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INTERMARKET COORDINATION ACT OF 1988

HEARINGS

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

S. 2256

TO PROVIDE FOR INTERMARKET COORDINATION

[REFERENCE TO THE STOCK MARKET CRASH OF OCTOBER 19, 1987]

APRIL 19 AND MAY 11, 1988

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THE INTERMARKET COORDINATION ACT OF 1988

TUESDAY, APRIL 19, 1988

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Sanford, Graham, D'Amato, and Hecht.

OPENING REMARKS OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

Gentlemen, we are delighted to have you here. We are anxious to make some progress in this area and proceed.

But, before we start, I have statements from Senators Sasser and Sanford and also a bill, S. 2256, that I introduced and without objection, placed in the record.

STATEMENT OF SENATOR JIM SASSER, SENATE BANKING COMMITTEE, APRIL 19, 1988

MR. CHAIRMAN, I AM PLEASED THAT WE ARE HOLDING ANOTHER HEARING TO ADDRESS LEGISLATION ON THE STOCK MARKET CRASH ON THIS SIX MONTH ANNIVERSARY OF THE CRASH OF 1987.

INDEED, I THINK THERE IS MUCH MERIT IN THE LEGISLATION THAT YOU HAVE INTRODUCED, MR. CHAIRMAN. I THINK WE NEED TO MOVE QUICKLY AND DECISIVELY TO MAKE SURE THAT THE REGULATORY AND OTHER CONDITIONS THAT CONTRIBUTED TO THE CRASH ARE CORRECTED.

WE ARE HEARING FROM A NUMBER OF SOURCES THAT COMPANIES ARE NOT RETURNING TO THE MARKETS TO RAISE EQUITY. WE ALSO KNOW THAT SMALL INVESTORS ARE LOOKING AT THE STOCK MARKET WITH GREAT DISTRUST.

THESE TWO FACTORS ARE PROBABLY RELATED. Indeed, THE PRESENCE OF SMALL INVESTORS IN OUR EQUITY MARKETS PREVIOUSLY HAS BEEN CITED AS A REASON FOR THEIR STABILITY AND STRENGTH.

THEREFORE, MR. CHAIRMAN, I THINK IT IS CRITICAL THAT ANY LEGISLATION THAT THIS COMMITTEE SUPPORTS HAVE AS KEY COMPONENT AN INSTRUCTION TO THE REGULATORS TO REMEDY ORDER EXECUTION PROBLEMS. IT IS THE SITUATION WITH ORDER EXECUTIONS THAT FIGURES IN MOST COMPLAINTS OF SMALL INVESTORS.

MOREOVER, I AM NOT SURE THAT THE ANSWER TO THE PROBLEM IN GENERAL IS THE CREATION OF ANOTHER INDEPENDENT FEDERAL AGENCY. I THINK IT IS IMPORTANT THAT WE MAKE SURE THAT CONGRESS' PRIORITIES ARE THOSE THAT ARE ADDRESSED BY THE AGENCIES AND THE EXCHANGES. THANK YOU.

OPENING STATEMENT OF SENATOR TERRY SANFORD

HEARING ON S.2256, THE INTERMARKET COORDINATION ACT OF 1988

APRIL 19, 1988

Thank you, Mr. Chairman. I appreciate your efforts in putting before this Committee legislation to address the concerns raised following the stock market crash in October. I look forward to hearing the testimony of our distinguished panel of witnesses on their reactions to the legislation that you, along with a number of members of this Committee, have introduced.

As you have clearly recognized, six months have now passed since Black Monday, numerous reports have been issued, certain positive steps have been taken to increase margins and specialist capital requirements and to increase information sharing, but not enough steps actually resulting in greater market coordination have been taken. We have all heard and few have disputed the central premise of the Brady Commission's report--that our equity, options and financial futures markets are integrally linked as one market and must be regulated as such. Yet no clear pattern of greater coordination has emerged. I read with some interest the very helpful Appendix to Mr. Bachman's testimony. That Appendix highlights the actions taken by the various self-regulatory organizations, the SEC, the CFTC, and the Administration since October 19, 1987. While many of those actions may make a great deal of sense, my concern is that despite all the talk of greater coordination, these actions were largely taken by the individual organizations involved without coordinating them with other market participants. I hope that through whatever steps are necessary, we can make this agreed upon concept of greater coordination in the regulation of our financial markets a reality.

I remain concerned that our market is very fragile. The 100 point drop in the market last week is, I believe, a troubling sign that despite the efforts made by the exchanges and the regulators since October 19, our market remains too volatile and too unstable. As a result, investors do not have enough confidence in the market to permit our market to perform its primary function--that of raising capital. I find it quite disturbing that initial public offerings remain sluggish and that many individual investors have not returned to the equity markets. I think this Committee must be willing to take the necessary steps to regulate our markets in a way that does restore confidence and stability, but we must be careful to balance our actions against the need to retain an open and liquid capital market.

Mr. Chairman, as we examine legislative proposals ~~to~~ for better ~~regulate~~ regulating our markets I believe that it is important to recognize the ways in which are markets have changed since our current regulatory structure was put in place. Institutional investors now make up the majority of the marketplace; derivative products and new technology have resulted in entirely new investment strategies and buying patterns; trading goes on around the world and around the clock; and a movement to valuing stocks more like a commodity or on a basis related to the break-up-value of the corporation rather than its worth as an on-going investment have fundamentally changed the way in which are equity market operates. We need to consider whether these factors, coupled with the lessons we have learned from the week of October 19, require a significant change to our regulatory structure, or whether fine tuning in the few areas that have raised serious problems is enough.

I look forward to this hearing to shed some light on these issues and to working with you, Mr. Chairman, as we develop a legislative response to the problems faced in our financial markets.

II

100TH CONGRESS
2D SESSION

S. 2256

To provide for intermarket coordination.

IN THE SENATE OF THE UNITED STATES

MARCH 31, 1988

Mr. PROXMIRE (for himself, Mr. RIEGLE, Mr. DODD, Mr. WIRTH, Mr. DOMENICI, Mr. CHAFEE, Mr. BOND, Mr. STEVENS, and Mr. MCCAIN) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To provide for intermarket coordination.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Intermarket Coordination Act of 1988".

SEC. 2. FINDINGS AND PURPOSES.

(a) FINDINGS.—The Congress finds that—

(1) the markets for equity securities, stock index futures, and stock index options (hereafter referred to as "equity instruments") have become one market,

linked by communications and computer technology and organized trading strategies;

(2) developments in communications and information technology have linked major financial markets and institutions around the world;

(3) the linkage of markets and institutions domestically and in the global financial system make it possible for a problem or failure in one institution or market to spread rapidly throughout the world;

(4) the relationships between these closely linked markets has created the need for a more carefully coordinated regulatory system both domestically and internationally;

(5) our present regulatory system does not adequately reflect the close linkages that have developed among the markets for equity instruments;

(6) regulatory issues of major importance overlap the individual markets for trading equity instruments and are beyond the authority of any one regulatory agency;

(7) there is an urgent and compelling need for the Federal regulatory agencies and self-regulatory organizations to work together and with financial regulators of other countries in a cooperative fashion to produce a

more coordinated system for regulating the trading of equity instruments; and

(8) a failure to develop a more coordinated system threatens to erode the confidence of investors in the integrity of our financial markets, thereby impairing the ability of those markets to fulfill their primary functions of raising equity capital for United States business firms and providing stable investment opportunities for investors.

SEC. 3. DEFINITIONS.

As used in this Act—

(1) the term "regulatory agencies" means the Securities and Exchange Commission and the Commodity Futures Trading Commission;

(2) the term "self-regulatory organization" means a self-regulatory organization as defined in section 3(a)(26) of the Securities Exchange Act of 1934, a contract market designated under the Commodity Exchange Act, a futures association registered under the Commodity Exchange Act, and any other self-regulatory organization operating under the oversight of the Commodity Futures Trading Commission; and

(3) the term "Committee" means the Intermarket Coordination Committee established by section 4.

SEC. 4. INTERMARKET COORDINATION COMMITTEE.

(a) ESTABLISHMENT.—There is established an Intermarket Coordination Committee (hereafter referred to as the "Committee") which shall consist of—

(1) the Chairman of the Board of Governors of the Federal Reserve System,

(2) the Chairman of the Securities and Exchange Commission, and

(3) the Chairman of the Commodity Futures Trading Commission.

(b) CHAIR.—The Chairman of the Board of Governors of the Federal Reserve System shall serve as Chairman of the Committee and shall preside at committee meetings.

(c) MEETINGS.—The Committee shall meet at least quarterly and otherwise whenever called by the Chairman or by two members of the Committee.

(d) MAJORITY VOTE REQUIRED.—The Committee may not take any action unless such action is approved by a majority vote of the members of the Committee.

(e) RELATIONSHIP TO CERTAIN AGENCIES.—The Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the self-regulatory organizations operating under the oversight of the Securities and Exchange Commission and the Commodity Futures Trading Commission, shall cooperate with the Committee in carrying out the purposes of this Act.

SEC. 5. COMMITTEE DUTIES.

(a) IN GENERAL.—The Committee is directed to promptly establish—

(1) improved intermarket coordination of clearing and settlement systems;

(2) harmonized margin requirements across marketplaces to control excessive speculation and financial leverage;

(3) circuit breaker mechanisms that are coordinated across marketplaces to protect the market system;

(4) information systems adequate for market surveillance and enforcement needs to include, at a minimum, information on the trade, time of the trade, and the name of the ultimate customer in every major segment;

(5) coordinated contingency planning for market emergencies; and

(6) effective methods for detecting and prohibiting intermarket frontrunning as well as other trading improprieties.

(b) INTERNATIONAL INITIATIVE.—The Committee is directed to promptly initiate discussions with the appropriate regulators of financial institutions and financial markets in major financial centers for the purpose of—

(1) enhancing the exchange of information relating to financial institutions and markets; and

(2) coordinating regulatory activities with respect to those institutions and markets.

(c) MANNER OF ACTING.—The Committee shall, to the maximum extent possible, utilize the expertise of the Board of Governors of the Federal Reserve System, the regulatory agencies, and the self-regulatory organizations to determine the appropriate actions needed to achieve the goals set forth herein. The extent that such actions can be implemented through the existing authority of the Board of Governors of the Federal Reserve System, the regulatory agencies, and the self-regulatory organizations, such bodies are directed to implement the actions so determined by the Committee. If the Committee determines that these bodies lack the necessary legal authority to implement the decisions of the Committee, the Committee shall report that determination to the Congress together with its legislative recommendations designed to accomplish the purposes of this Act.

SEC. 6. ADMINISTRATIVE PROVISIONS.

(a) EXPENSES.—Pursuant to assessments levied by the Committee, the regulatory agencies shall each pay the Committee an amount equal to one-third of the Committee's expenses. The Committee shall levy annual assessments based upon its projected annual budget and such additional assessments as may be necessary.

(b) GENERAL POWERS.—In addition to the powers granted to the Committee elsewhere in this Act, for purposes of carrying out the provisions of this Act, the Committee shall have power—

(1) to enter into contracts, to execute instruments, to incur liabilities, and to do any and all other acts as may be necessary and incidental to the conduct of its business;

(2) to sue and be sued, complain and defend, in any court of equity, State or Federal;

(3) to use the United States mails in the same manner and under the same conditions as other Federal agencies;

(4) to appoint and fix the compensation of such officers and employees as are necessary, subject to the provisions of title 5, United States Code, relating to the competitive service, classification, and General Schedule pay rates;

(5) to obtain the services of such experts and consultants as are necessary;

(6) to lease, purchase, or otherwise acquire, own, hold, improve, use, .or otherwise deal in or with, and

sell, convey, mortgage, pledge, lease, exchange or otherwise dispose of, any property, real, personal, or mixed, or any interest therein, wherever situated;

(7) to adopt, amend, and repeal regulations relating to the conduct of its business and the exercise of all rights and powers granted by this Act; and

(8) to directly require reports, data, and other information from the regulatory agencies and from the self-regulatory organizations.

(c) TEMPORARY USE OF AGENCY PERSONNEL AND FACILITIES.—In carrying out its functions under this Act, the Committee may utilize the personnel, services, and facilities of the regulatory agencies or any Federal Reserve bank with the consent of the regulatory agency or bank and with or without compensation.

SEC. 7. REPORTS TO CONGRESS.

The Committee shall report to the Congress, at least quarterly, with respect to the progress being made by the Committee in performing the duties set forth in section 5 of this Act. After the Committee reports to Congress that such duties have been performed in substantial part, the Committee shall make an annual report to Congress on both domestic and international intermarket coordination and include any specific recommendations for legislative or administrative actions.

The **Chairman**. Please proceed.

Mr. **Bachmann**. Actually I think I will be making the statement, so we are here together.

Mr. **O'Brien**. It's "BOB" this morning, Senator.

STATEMENT OF JOHN W. BACHMANN, CHAIRMAN, SECURITIES INDUSTRY ASSOCIATION; ACCOMPANIED BY EDWARD I. O'BRIEN, PRESIDENT, SIA AND JEFF SCHAFFER, ECONOMIST, SIA

Mr. **Bachmann**. I am John Bachmann, chairman of the Securities Industry Association and the chief executive of Edward D. Jones & Co., a registered broker-dealer with headquarters in St. Louis, MO, and about 1,340 offices in 38 States serving approximately 1 million households. I am accompanied by Edward I. O'Brien, president of SIA.

[The complete prepared statement of Mr. Bachmann follows:]

Statement of
SECURITIES INDUSTRY ASSOCIATION
Concerning the October Market Break
Before
Committee on Banking, Housing and Urban Affairs
United States Senate
April 19, 1988

I am John W. Bachmann, Chairman of the Securities Industry Association (the "SIA") and the chief executive of Edward D. Jones & Co., a registered broker-dealer with its headquarters in St. Louis, Mo., and about 1,340 offices in 38 states servicing approximately 1,000,000 households. I am accompanied by Edward I. O'Brien, President of the SIA.

We appreciate the opportunity to appear before you today to present the SIA's views on the market break of October 19-20, 1987 and some of the proposals designed to prevent a recurrence of the events of those days.

The SIA has not conducted its own study. Rather, we have read the available reports and discussed their conclusions and recommendations with representatives of the securities industry. While we may not have all the answers, based on conversations with many of the involved parties, we have some views which we hope will be useful. In addition, we shall attempt to answer any questions you may have.

We start from the premise that there are two considerations of overriding concern: (1) the importance of our capital markets to the formation of capital in this country, to the efficient transfers of capital and to the ownership of American business by individual and institutional investors and (2) the importance of investor confidence in our capital markets.

We recognize the events of October 19-20 to be of great significance and concern. They brought to light weaknesses in our markets for securities and securities derivative products and perhaps their regulation -- regulation designed for a diffferent age and whose evolution was not planned. Individual investors hold approximately 60% of publicly traded stocks other than mutual fund shares, but the events of October 19-20 have driven many of them away from the market. This hurts the vast majority of our members. The events of those days have also adversely affected investors' appetite for new equity offerings, especially initial public offerings. This, of course, hurts the nation's ability to raise capital for new enterprises.

However, the events of October 19-20 should be viewed in their proper historical perspective. Institutional investors have assumed an increasingly important role in the marketplace. The market has become increasingly internationalized as many securities are traded worldwide, many investors participate in markets around the world, and what happens in one part of the world affects what happens in other parts. The size of transactions has increased as a result of block trades, portfolio restructurings and program trades designed to replicate various stock market indices. The volume of transactions has increased dramatically. The velocity of trading by portfolio managers has increased. Developments in technology have facilitated the increases in volume and velocity. Institutions are trading securities like commodities and executing large transactions in short timeframes, for relatively modest profits.

Thanks to trading, clearance and settlement mechanisms put in place by the securities industry at great expense and notwithstanding the fact that volumes on October 19-20 were at or beyond the outer limits planned for, the securities industry handled the events of October 19-20 better than anyone could have expected.

The events of October 19-20 have taught the marketplace a number of lessons:

-- Trading strategies that depend on instantaneous execution and infinite liquidity are deficient.

-- Markets, and particularly transactions between markets, do not act as smoothly as computer models assume and predict. Computers break down, switchboards become overloaded, severe order imbalances lead to trading halts, etc.

-- Everyone cannot sell at once. There are limits to what the marketplace can be expected to absorb in a short timeframe when there is a severe sell order imbalance.

-- Traders' strategies are frequently apparent to others and affect each other's trading decisions.

-- Mutual funds must maintain greater liquidity to provide for transfers within a fund complex or withdrawals by wire transfer.

We believe that it is critical to study and learn from the events of October 19-20. Undoubtedly, it will be appropriate to improve the availability of information, the operation and coordination of the separate marketplaces (whether they constitute but one market or several interrelated markets) and their regulation.

But we believe that it is necessary to proceed with caution before implementing any changes affecting the securities markets. The regulatory agencies, the SROs and the securities industry should be given an opportunity to experiment with changes and coordinate their regulations within existing law. The SROs have already taken many steps, and are considering others, to reduce the chances of another October 19-20 and improve their response to it if it does happen. In an Appendix to this testimony we have listed some of the more important steps already taken or proposed to be taken by the SROs. The pace is painfully slow, and their activities must be better coordinated. Unilateral actions by SROs should be avoided. Any addition to the bureaucratic superstructure that will increase cost and reduce efficiency should be approached with the utmost caution. We should also make every effort to know the consequences of changes before implementing them. For example, it is not in the U.S. national interest to drive business offshore by unnecessarily curtailing or restricting securities products or trading strategies.

We have the following recommendations, all designed to restore and strengthen public confidence in the securities markets:

-- The securities markets and securities-related futures markets are so interrelated that they should be regulated by one regulator. The responsibility for the supervision of these related markets should be lodged in one place, not dispersed between two regulatory agencies that may have a predisposition to advance the interests of their respective constituencies to the detriment of what should be done in the overall national interest. Accordingly, we consider this approach to be preferable to that contemplated by the proposed Intermarket Coordination Act of 1988.

-- This should be accomplished by a realignment of existing regulatory authority, namely by transfering to the SEC jurisdiction over the securities-related portion of the futures markets. The market for the derivative products should be under the same governmental oversight as the primary market. We recognize that the Brady Commission shied away from

this recommendation, and its Chairman has continued to view this proposal as politically impracticable. However, it was the Brady Report's central finding that these are in reality a single market. Accordingly, we believe that unified regulation is the correct course of action and should be vigorously pursued by the Government notwithstanding the political obstacles it faces.

-- The same market interrelationship requires that determination of margin requirements with respect to both securities and securities-related products should be centralized in the Federal Reserve Board. The Federal Reserve Board, after studying the proper relationship between margin for securities and good faith deposits for securities-related products, should allow cross-margining and prescribe from time to time the margin requirements appropriate for both securities and securities-related products.

-- Better information should be available on a more current basis with respect to positions and clearance in both securities and securities-related markets. The clearance and settlement mechanisms relating to securities-related products and those relating to "conventional" commodities should be separated, and those relating to securities-related products and those relating to securities should be closely coordinated.

The **Chairman**. Thank you, Mr. Bachmann. Mr. O'Brien, did you have a separate statement?

Mr. **O'Brien**. No, I do not, Mr. Chairman.

The **Chairman**. Fine. I want to thank you for an excellent statement and one that I think we can build on. It's vital that we take action, as we were told by Mr. Brady. He put it in kind of a dramatic way. He said that we have a pistol pointed at our head and it's loaded, meaning, of course, that we could have another black Monday or terrible Tuesday. We were reminded of that only a few days ago when the market fell over 100 points. We still have a volatile market and we're paying a severe price.

Mr. Bachmann, we have heard various reports about investors leaving the market. Does the SIA have any statistics to illustrate the exodus and can you tell us of the experience of your firm? You have one of the larger retail brokerage firms in the country.

Mr. **Bachmann**. I would have to defer to Mr. O'Brien as far as industry numbers. I can speak to our own experience.

Mr. **O'Brien**. I don't think, Mr. Chairman, there is any reliable statistical evidence to show how many have left the market or have not returned to the market, at least to the best of my knowledge. I think it is undeniable for those of us who have been involved with the industry for 20, 30 or whatever number of years it is, that the individual investor left the market in great measure as a result of the October events and he has not returned to that market to any substantial degree.

In other words, even without the statistical evidence, it is demonstrable in our opinion that the individual investor has stayed away from the market. Now many questions might be asked as to whether it is simply because of the October events or other factors as well, and my personal view is it is a combination.

Mr. **Bachmann**. Our experience at Jones is that in the first quarter of this year compared to a year ago, our revenue per investment representative, which is a key measure for us, is down by one-third. So that's a significant drop.

The Chairman. I've seen other disturbing statistics. If you compare the 4 months before the October crash with the 4 months following the October crash, there's been a very severe, dramatic dropoff in new equity issues, particularly secondary issues. The initial issues have dropped off, about 80 percent and the secondary issues have dropped off 95 percent.

Now in view of the fact that the markets serve two purposes—one is for investors, the other of course is for the capitalization of our industry.

Can you give me your observations on what experience you gentlemen have had with the dropoff in new issues?

DECLINE IN NEW ISSUES

Mr. **Bachmann**. Well, we're the, I suppose, the exception to the rule. Our public is entirely retail and of the offerings since October 19 through the rest of the year I believe there were five and Edward D. Jones underwrote three of them. This year we did the financing for Potomac Electric, your local utility, a large convertible offering, because there is some interest in the individual retail market for conservative utility type issues, but in general we find a couple of things that affect the market. One is the investors are not eager to come in and the other is the severe price drop has discouraged corporations from going to the equity markets now because they think in terms of the higher prices they saw about a year ago.

The CHAIRMAN. Mr. Bachmann, your recommendations emphasize that we should have one regulator and that should be the SEC. You also suggest the Federal Reserve should set the margin requirements in the futures market. Of course, that's controversial and, as you know, it's going to be a real political struggle. If we can't accomplish what you desire because of the political difficulties, would you rather have the status quo or the bill that has been introduced by members of this committee, including myself, which creates a forum for intermarket coordination and harmonization of margin requirements between the stock and stock index futures markets?

Mr. BACHMANN. It seems to be that given a choice between events simply floating along or having some group to focus attention on these issues as you suggest, the latter would be preferable of the two.

The CHAIRMAN. Do you agree, Mr. O'Brien?

Mr. O'BRIEN. I do, Mr. Chairman, but I think I would work very hard to try to get the single regulator first, namely the SEC. But in answer to your question, I agree with you.

The CHAIRMAN. We have not only the problem with people in Chicago who of course are very concerned about losing their operations and they are efficient people——

Mr. O'BRIEN. Yes, they are.

The CHAIRMAN [continuing]. Who have done a fine job, but we also have a jurisdictional problem in the Congress. We have the Agriculture Committee in the Senate, the Agriculture Committee in the House, that has jurisdiction over the Commodity Future Trading Commission, and while we think this is an equities problem, a securities problem, and should be treated as such, we have a very difficult problem involved here.

Mr. O'BRIEN. Yes. We're very sensitive to that.

Mr. BACHMANN. Could I say one thing?

The CHAIRMAN. Yes.

Mr. BACHMANN. Since October 19, I have probably spent as much time as just about anybody going around visiting with various parties, firms, regulators, self-regulators, you name it. Probably the single thing I hear more than anything else is, if we were to design the system today we would design it differently. When you hear that over and over and over again, as I have, it raises the issue in light of the problems we've had, should we not make every effort to come up with that design? That's a troubling question.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Do either of you have an estimate of the percentage of common shares that are now in the hands of individual investors and held by them or by brokers for them versus the number of common shares that are held by pension funds and institutional investors?

Mr. BACHMANN. We have relied on the figures from the Brady report. The Brady report is the first time I've seen that number as sharply defined, and they I believe say that 60 percent of all shares are held by what are called households, which would be, in my interpretation, individuals. That does not include shares held by mutual funds, which would probably on the equity side push that up to perhaps as high as 75 percent.

Senator RIEGLE. Now do either of you have good estimates as to how much of the trading volume in a given week or month or year comes from one category, the household investment category, versus the institutional investor or the pension fund type investors?

Mr. O'BRIEN. I'm going to ask Jeff Schaffer, who is our economist at SIA. He may have a notion on that. We produce an investor report which shows some of this information, individual investors, institutional investors, and is prepared by Jeff's department. I think he may be able to help.

Mr. SCHAFFER. Basically, for the first 2 months of 1988, if you include member firm trading as principals in so-called institutional category, it would break down to something like 77 institutional member firms trading and 23 percent retail trading. About a year ago, those same figures would break down to about 70 percent versus 30 to 31 percent, the same categories, institutions plus member firms trading.

Senator RIEGLE. Now can I conclude from that that the roughly 23 percent then would constitute the volume that is actually being traded by households per se or not?

Mr. SCHAFFER. Yes, I think so. That's a close substitute for it.

Senator RIEGLE. One of the things I'm wondering as we see that the Brady Commission has pointed out the development of a single market, albeit with different segments, but a one market system that's interconnected and the fact that as more and more of the stock holdings are accumulated in the hands of institutional type investors—pension funds and others—and as a very substantial part of the trading volume also is done by those holders of securities, common shares start to take on a commodity type character and it seems to me that one of the things that's happened here is this cross-connection between the underlying securities market and then the derivative options and futures market relates to the fact that the volume of trading and who holds the shares has been undergoing this secular change and that we're finding very large accumulations of stock and even a larger part of the trading volume are coming from major managers of stocks rather than individual households.

It seems to me that that fact, if that's right and it seems to me to be that that's what's happening, is very much a part of this story of how you now have this cross- connection between these two markets. Now you've got a lot of other things thrown in—this index arbitrage—when you get these disparities between the underlying securities market and the futures market, along with program trading and portfolio insurance and other things that have come along to in a sense try to facilitate this change in character where more and more of the trading that's going on is really of an institutional sort and where stocks are becoming more like commodities.

I don't quite know what to make of that because it's a change in character that I think is very different than the fundamental view that we have when people talk about the inherent value of the stock and how well it's likely to perform and whether an individual should invest in it all the way over to the question of whether or not people who are very large managers of blocks of stock are in and out on the 1/2-hour or every 2 or 3 minutes or in and out during the trading day, moving these stocks around more or less as commodities, as investment devices that are quite different than I think we've tended to view the traditional notion of how capital is to be raised by the sale of stock.

I think understanding that change in circumstance and where that's going is very important in understanding how we devise a mechanism to handle this single market that the Brady Commission talks about. My hunch is that what has happened—and you've confirmed this in part today—is the volatility of the stock market, the sharp drops, have scared away the individual investor and so they are now a smaller percentage of the total than they were before and, therefore, the institutional investors moving large blocks around are automatically a larger part of the market.

I noticed, Mr. Bachmann, that you did not specifically call for—unless I missed it here—the implementation of any kind of a circuit breaker that would shut the market down for a period of time. What are your thoughts on that?

CIRCUIT BREAKERS

Mr. **Bachmann**. Well, we believe that there at some point must be circuit breakers, but what we would like to see is the single regulator orchestrate those. We would like to see the individual self-regulators come up with suggestions. There are some real problems here. A concern we have is that the exchanges coming up individually with "circuit breakers" can exacerbate the problem and there's a real lack of understanding as to what unilateral activities in one market do in other markets and we've seen that over and over again brought into question.

My main concern would be as long as you have a single market or a single linkage of markets and you have the ambiguity of multiple regulation, where the regulators do not have identical interests and do not have identical constituencies, it seems that we're violating one of the basic principles of responsibility, which is you fix it in one place and the minute that there's ambiguity I think that that cannot work to the market's benefit. I think you want to fix responsibility in one place and charge them with working with the various organizations to come up with the appropriate circuit breakers. I don't know what those are and I don't know who does.

Senator **Riegle**. There were stories last week to the effect that John Phelan and Leo Melamed, representing the New York Exchange and the Chicago Mercantile Exchange, and presumably maybe others were talking about the possibility of a circuit breaker that would shut the market down totally, as the stories were written, if you had a price break in the Dow Jones in one day of somewhere between 200 and 300 points.

How do you react to that? I would be interested in both your thoughts.

Mr. **O'Brien**. My first reaction is that we also understand from pretty reliable sources that Phelan and Malamed are discussing some of these things and we think that that is really necessary and we're very glad to see it. We've encouraged it. As a matter of fact, John and I have visited the exchanges personally and talked about some of these different things. So we very much think that's necessary and the reason is that the coordination is essential in this context and especially by people who have the particular expertise. They're dealing with these things on a daily basis.

As far as putting in circuit breakers are concerned, where they should be placed, I would say my own view is that there is an appropriate point for circuit breakers when markets no longer represent price validity. Where that is is best known by those who are dealing with those markets themselves each day.

For example, if you were to talk with people on the floor of the New York Exchange or for that matter at the Mercantile Exchange, you would find that they know this quite well. They can sense, they can feel. That, for example, has not been my history in the industry but on the other side of the business. So I think it's necessary when that validity of pricing goes awry or doesn't exist we're in favor of it.

Mr. **Bachmann**. I think our experience, Senator, going back and looking at what happened on October 19th and 20th at our firm, which I mentioned is entirely retail, when the market plunged our customers became aggressive buyers. There was no panic in the retail markets. All they saw were bargains.

The trading volume at Jones was 10 to 1 on the buy side. It was basically in quality issues. The top three were—I'm talking about individual securities—Walmart, Eli Lily, IBM—names that are in our market household names and well regarded companies.

But when you get in the kind of free-fall plunge where you have sellers who have no economic concern with intrinsic value, which is what happens in those situations—and we've heard money managers say, "We don't care if the market goes to zero because we make so much on our index transactions," well, those kinds of imbalances where you get so much selling the market in such a short time that triggers in other selling clearly indicates that if there was a pause there's a real chance that buyers may come into the market.

One of the problems we have is our technology has so outrun our ability to understand what it's doing simply because of the speed of it that we don't have time to react. When I was a board marker back in 1959, we traded 1,900,000 shares a day. Six months ago on the New York Stock Exchange, 80 million shares traded in 1 minute. And you have basically the same regulation. I think that we've got to slow things down enough at times that people who are concerned about intrinsic values have time to react.

Senator **Riegle**. Is it fair to say that the SIA would then support establishing circuit breakers that at some point would actually close the market for a period of time or close, say, all markets at a point in time at least for a period of time?

Mr. **Bachmann**. I think the SIA is concerned that our markets not be destroyed and if that's the price we have to pay, then at some point I think we have to favor those kinds of activities, even though we find them very distasteful. They may be the lesser of the evils.

Mr. O'Brien. We've been brought up with the idea that you keep markets open as long as you possibly can so that investors, even those who choose to perhaps come in at a time when you and I might not be interested in it, can obtain execution of trades. But there can come a time when it is the right thing to do. So the answer would be yes.

Senator Riegle. I find myself also with the same impulse of being very reluctant to close markets and the whole question of how long and how you reopen them—I mean there's a lot of arguments for keeping the system going if we possibly can.

The other side of that is that it seems to me that all of these radical changes that have come in the last few years with new kinds of instruments, difference in trading patterns, the cross-connection of markets, a global market, the difficulties of trying to rationalize the regulatory arrangements and so forth, have created a situation where until we work out the refinements and the self-regulatory organizations are implementing certain things, and we saw in a sense some partial test of that last Thursday when the trade figures knocked the Dow down 101 points in 1 day and you went through the 50-point swing on the New York Exchange which kicked off the automatic block trading but then it's of course done by hand so it seems to me we're experimenting with how we make a whole series of very complex adjustments. I'm wondering if, as we go through that period of figuring out how you take and do some reengineering so that the system really works as well as we can make it work, if circuit breakers have one kind of a character as you're in that transition and maybe they have a different kind of a character once you're through it. I don't know. I mean it seems to me that right now we're in a situation where there's a lot of apprehension.

I'm struck by the fact that when the Brady Commission comes back after doing a lot of serious work, Nick Brady being a professional in this business over the years as are you and other witnesses that we will hear today, says that we're looking down the barrel of a loaded gun, that's pretty strong language from a person who has I think sort of a history of moderate conduct and observation and so forth.

Are you two apprehensive right now that we're in a vulnerable position until further steps are taken to resolve some of these issues?

FUTURE IN DOUBT UNTIL STEPS ARE TAKEN

Mr. Bachmann. I think you may get two different answers on this one.

Mr. O'Brien. That's truly the $64,000 question. First of all, I don't even know what the market is doing today, but that's irrelevant I suppose. Yes, I think one has to be sensitive to what can happen in these markets when so many worldwide events can impact on it, and at the same time you have the domestic events which I won't recount. Everyone in this room is very familiar with them—deficits of one sort or another, political fear and so on. So, yes, I am concerned, somewhat apprehensive, that the situation has to move forward, but I would only have one other point to make.

In my years in the industry, I don't recall any instance in which the industry itself—I really cannot recall a single instance where the industry itself has really striven to try to do something—and we've listed some of those in the appendix to our statement—I think the industry has tried quite hard—there is no one that I have met who takes this in a cavalier or a casual fashion. They are really trying to do something about it and without attempting to ingratiate myself, I think it's to the credit of the government, wherever it happens to be, that it has permitted that practice to go forward. In other words, the initial point was, let's jump down on their throats and get something done. In 6 months a lot has been done.

But to answer your basic question, more is needed and I think the progress could have been greater at this stage of the game and I would hope it will accelerate.

Mr. BACHMANN. I'd like to answer that as well. I have probably greater reservations, greater concerns, in that area. If we look at what's changed since October 19th, probably the thing that is easiest to define that has changed—and I will take our own company—we didn't get all our orders to the floor in a timely way. We ran into backups at every stop along the way.

What have we done since then? Well, we have five times as many lines going into the New York Stock Exchange. We have twice as many lines going into the Midwest Stock Exchange as we had. If the situation similar to October 19 were to happen again, our ability to enter orders has been greatly magnified. I believe you would find that's true of every other securities firm that was in the market. I think you'll find it's true of every service bureau and the exchanges themselves.

So that the circumstances of October 19 and 20, if they were to repeat in an identical fashion and if the regulators were not to move more quickly, which I happen to think they would move much more quickly—but were they not to move more quickly, I think it would compress dramatically the time in which it took where we arrive at where we arrived at noon the 20th simply because we have added a great deal of efficiency to the system.

My deep concern is that things are moving so slowly in coming up with the coordination between the various major markets it leads me back to the belief that the single regulator and the single regulatory oversight for this is the most appropriate solution because I still am unable to push from my mind the sense that exchanges, while they are quasi public institutions, are still very much like businesses and competitive advantage is very important. Order flow is very important. And if a system is going to permit order flow to increase or to be maintained when it may not be maintained somewhere else, if there's any competitive advantage, then it causes the regulator or the self-regulator or anyone else to be torn between loyalties, and I don't criticize anyone for this. I think everyone in October 19 and 20 basically behaved the way the system was designed for them to behave. My concern is that unless you have that single regulation with that accountability and responsibility with it, it creates what I consider an unacceptable ambiguity.

Senator **Riegle**. Just two other things here. When you look at the events—there's a piece in this morning's *Wall Street Journal* which you may or may not have had a chance to see yet on an SEC study looking at the stock slide that took place on January 8 of this year and the thrust of it is it's the judgment of the SEC that program trading in the form of index arbitrage "may have accelerated the steepest portion of the market decline," and the market went down 140 points that day.

Thinking back to January 8 and that's fresh in your mind to some extent, but going back just to last Thursday, I'd like to know your reactions to what you feel was taking place there when the market began to go down off that trade data news at the speed that it did and it went through the 50 point tripwire on the New York Exchange in terms of automated program trading, what's your sense, each of you, as to what the dynamics were at work there last Thursday and how much of a concern is that to you?

Mr. **Bachmann**. I'd like to start out by suggesting that people and institutions have become so nervous and so sensitized to these market fluctuations that just their own nervousness is going to tend to exaggerate which makes it difficult to define it. The New York Times this weekend or Monday came up with five different scenarios for what happened, so it suggests that there is no clear right answer.

My understanding is—and I have checked on this—is that there was index arbitrage taking place in the market on Thursday and that this in fact did exaggerate the moves. But I don't see how it's going to keep from happening as long as that mechanism is there, and I don't know that that's all bad. In other words, if we have a single market, you have to have some mechanism to keep those markets in equilibrium. Ultimately, our economic system demands it.

By the same token, I think that the study that the SEC did brings us right back to my basic theme, which I apologize for hitting over and over again, but Mr. Ketchum, who headed that study, said that it is a single linked or a linked market, which in effect brings us back to the fact that there is a unity there that cries out that we not have this ambiguity that's in the system now.

Senator **Riegle**. I don't know whether you want to add anything to that, Mr. O'Brien.

Mr. **O'Brien**. Well, not a great deal, Senator, except to say that I tend to agree with what I read in the paper as to the SEC report. I haven't seen it. As you know, it's only just out.

I still have sort of a nagging feeling that we don't quite have a handle on how to handle the thing yet and that it could happen again in some form, not exactly the same. I don't think things exactly happen the same, but I also believe—and John indicated himself—that we have a slightly different point of emphasis—I think a lot has been done but I'm not quite convinced that we have closed the loop completely.

Senator **Riegle**. Let me ask one final question and then I will see if Senator Sanford has something here, too. That is, on capital formation, it's very interesting to the discussion which took place ear-

-- We believe that the SEC, the Federal Reserve Board and SROs in both the securities and securities-related futures areas must work together and that the SROs should be encouraged to experiment with changes and institute reforms within existing legal authority before cumbersome legislative and regulatory solutions are imposed. While the SROs have made some progress, we believe that their efforts should have been better coordinated and that they should have accomplished more by now. We would recommend the organization of an SRO inter-market coordinating council consisting of appropriate representatives of the stock exchanges, the National Association of Securities Dealers, the futures markets and the National Futures Association - all subject to the oversight of the SEC. Such a group should be required to meet regularly and charged with the responsibility to come up with coordinated measures to reduce the likelihood of a recurrence of the events of October 19-20. The SIA is prepared to assist in this process.

-- While the mechanisms for trading halts ("circuit breakers") within markets and between markets (both domestic and international) should be improved and coordinated, we believe that the objective should be to keep the securities markets, and trading in the

individual securities, open to the maximum extent possible.

-- We affirm the importance of firms giving priority to customers' trades over firms' proprietary trading.

-- Our markets should continue to be open to innovative securities and trading strategies. However, it may be appropriate for SROs to consider imposing on derivative products trading controls designed to reduce price volatility and, in appropriate circumstances, slow things down a bit.

-- The short sale rule with respect to equity securities should be preserved, notwithstanding the fact that a similar rule in the equity-related futures area is not feasible.

If you have any questions, we would be pleased to try and answer them. Thank you very much.

Appendix

ACTIONS TAKEN SINCE OCTOBER 19, 1987

WORKING GROUP ON FINANCIAL MARKETS

- "Working Group on Financial Markets" formed March 18, 1988, consisting of senior representatives from Treasury Department, SEC, CFTC, and Federal Reserve Board. Chairman is Treasury Undersecretary George Gould. Plan to issue findings within sixty days of formation after determining differences among various market break studies; not clear whether will issue legislative recommendations. (Bureau of National Affairs Daily Report for Executives, pp. A-4, A-5, March 24, 1988)

NATIONAL ASSOCIATION OF SECURITIES DEALERS

- Proposed amendments to rules regarding Small Order Execution Service ("SOES") and Market Maker Practices published for public comment in March 22, 1988 Federal Register. Would make SOES participation mandatory for all marketmakers in NASDAQ/NMS securities, prohibit marketmaker withdrawal unless for an accepted reason and prohibit unexcused withdrawn marketmaker from re-entering NASDAQ as a marketmaker for 20 business days. [SEC Release No. 34-2565 (March 15, 1988), 53 FR 9391 (March 22, 1988); See also NASD Notice to Members 87-77 (November 20, 1988)]

- In January 1988, implemented new computerized Order Confirmation Transaction program, providing another way, in addition to telephones, to execute trades during periods of heavy volume. Permits greater access by traders to market makers. (Securities Week, January 18, 1988)

- Proposed enhanced confirmation comparison capability -- called ACT ("automatic confirmation transactions") -- will substantially eliminate back-office paperwork for market making firms by reducing number of failed, uncompared or DK trades. Needs SEC approval. (Securities Week, December 28, 1987)

NEW YORK STOCK EXCHANGE

- Considering halting all automated program trading on days when Dow Jones Industrial Average moves more than 150 points. Also considering, with Chicago Mercantile Exchange, a cross-market trading halt on days when Dow Jones swings more than 250 to 300 points. (New York Times, April 13, 1988; Wall Street Journal, April 15, 1988)

- On April 13, 1988, announced consideration of adoption of interpretation prohibiting intermarket frontrunning. [NYSE Information Memo (April 13, 1988)]

- On April 7, 1988, voted to increase capital requirements for its specialist firms from $100,000 in capital or enough capital to buy as many as 5,000 shares in which they make a market to $1 million/15,000 shares. Needs SEC approval. (New York Times, April 8, 1988)

- Proposal published for public comment in March 23, 1988 Federal Register seeking SEC's permanent approval of NYSE policy for reviewing combinations among specialist units. [SEC Release No. 34-25481 (March 17, 1988), 53 FR 9554 (March 23, 1988)]

- Proposal published for public comment in March 7, 1988 Federal Register which would prohibit member firms from using "Super Dot" system for index arbitrage if Dow Jones Industrial Average has moved 50 points from the prior day's close. [SEC Release No. 34-25400 (February 26, 1988), 53 FR 7273 (March 7, 1988)]

- Implementing 10 major enhancements to address overload problem on October 19, 1988, including new Automated Pricing and Reporting System and increased DOT system memory. (Securities Week, February 22, 1988)

- On October 21, 1988, filed proposal with SEC seeking approval of new Super Dot PC computer system and associated features with SEC to upgrade computer capabilities for peak volume days. Provides alternate route to input trades and gives upstairs firms access to exchange via personal computers in the event of serious systems failure. (Securities Week, December 28, 1988)

AMERICAN STOCK EXCHANGE

- On April 14, 1988, announced Board approval of increased margin requirements for an initial six-month period on broad-market stock-index options from 10 to 15% (had been raised from 5% in November 1987) and on narrow-market index options and individual stock options from 15 to 20%. Needs SEC approval. (Wall Street Journal, April 15, 1988)

PACIFIC STOCK EXCHANGE

- Hosted March 28, 1988 meeting of representatives from regional exchanges to discuss performance issues. (Securities Week, April 4, 1988)

COMMODITY FUTURES TRADING COMMISSION

- Considering a program of sharing financial information on futures firms that are dually registered as broker/dealers and futures commission merchants (FCMs), particularly information on positions carried by large dually registered FCMs. Also working on program to aggregate more efficiently information on the exposure of FCMs in similar contracts traded on different exchanges and conducting feasibility study on how to speed up current information-sharing mechanisms. (Wall Street Letter, February 29, 1988)

CHICAGO BOARD OPTIONS EXCHANGE

- Adopted modified rotation process to provide for a more rapid opening for S&P 100 Index Options ("OEX"). New procedure will reduce the average time for opening rotations to about 10 minutes and should reduce problems associated with delayed open trading, especially during extreme market conditions like in October 1987. [SEC Release No. 34-25545 (April 7, 1988), 53 FR 11720 (April 8, 1988)]

- Filed proposal with SEC to increase margin rules from 15 to 20% on equity options, 10 to 15% on index options; proposed minimum 10% for both equity and index out-of-the-money options (about 50% increase from current requirements.) Also proposed that changes be adopted by all options markets. (Securities Week, April 4, 1988)

CHICAGO BOARD OF TRADE

- February 4, 1988: Raised initial margin requirements on stock-index futures to about 15%. Raised initial speculative margins on its Major Market Index stock-index futures contract to $15,000 per contract from $12,000. (Had been raised from $5,000 in late October 1987.) Also offered to share its computerized trade-monitoring system with New York Stock Exchange. (Wall Street Journal, February 5, 1988)

- Week of December 14, 1987: Announced plan to place price limits on Major Market Index and Institutional Index contracts. (40 points increase or decrease limit). (Securities Week, December 21, 1987)

- April 14, 1988: Considering, with NYSE, cross-market trading halt -- on days when Dow Jones Industrial Average swings 200 to 250 points. (Wall Street Journal, April 15, 1988)

CHICAGO MERCANTILE EXCHANGE

- December 1987: Raised initial speculative margins to $15,000 on S&P 500 futures. (Wall Street Journal, February 5, 1988)

- October 1987: Set price limits (30 points increase or decrease limit) for 90 days on S&P's 500 stock index futures. (Securities Week, December 21, 1987)

INTERMARKET SURVEILLANCE GROUP

- April 1988: Formed a subcommittee to develop a definition of frontrunning. (Securities Week, April 11, 1988)

- Senior SEC and CFTC staffers chaired March 16, 1988 meeting with representatives of futures, stock and options exchanges to discuss sharing of market surveillance information among exchanges. Also, several meetings among the top executives of futures, stock and options exchanges were held this year in order to provide a forum to discuss increased communication and coordination during volatile markets. (Securities Week, March 21, 1988)

- March 1988: Invited CME and CBOT to join Intermarket Surveillance Group. (Securities Week, March 14, 1988)

- Six SROs' revised frontrunning enforcement policies were published for public comment in the January 6, 1988 Federal Register. Revised circular broaden scope of SROs' respective frontrunning enforcement policies to index options and over-the-counter options. [SEC Release No. 34-25233 (December 30, 1987), 53 Federal Register 296 (January 6, 1988)]

MONITORING COORDINATION GROUP

- An informal organization composed of representatives from equity and options clearing corporations adopted plan to meet at least once per quarter and submit an annual report to the SEC. (Securities Week, March 14, 1988)

WORKING GROUP CONSISTING OF OFFICIALS FROM ALL EXCHANGES AND CLEARINGHOUSES

- Met on February 25, 1988 to focus on information sharing and financial viability of member firms. (Securities Week, April 4, 1988) lier with Senator Proxmire about the sharp decline in new stock offerings and secondary offerings and I know there's been some pickup more recently but I don't know what the events of last week will do to that.

Have we seen real damage done here to the capital formation process?

CAPITAL FORMATION

Mr. O'Brien. I think that the capital formation process has unquestionably been slowed down. However, the capital formation process periodically does slow down for a variety of reasons, whether it's pricing, economic conditions, tax laws, perception of the economy and lots of things. So whether it's all attributable to the events of October 19 and 20 and their aftermath is something I can't answer, but I think it cannot be ruled out as having had a bearing.

The fact of the matter, we do not do IBO's any longer and that means that we're not raising as much capital.

Senator Riegle. Well, I'm really interested in an answer to a tougher question than that. Let me make it tougher. That is, do we have a problem that has now developed that is serious with respect to our ability to raise equity capital for new businesses or to finance the size of businesses that want to grow? I'm not talking about money for leveraged buyouts or takeovers. I'm talking about money to start companies and to grow companies. The clear impression that I have is that we have got a serious problem in that area.

Now am I wrong about that? If I am, put my concern to rest.

Mr. Bachmann. In my view, Senator, we have the short- term problem that could become a long-term problem if we don't address the problems of this tremendous volatility that is unrelated to intrinsic values. The market is supposed to be volatile when international events or when surprises take place. The market volatility I think to investors somehow has to reflect what they see in the world for them to have a degree of confidence. I think if we go through another major shake like we had it would be a long time restoring confidence. At this point we've found—and I have to say in our own organization—that there is still a market out there, but part of the problem is that companies got prices for selling their equity fixed in their mind back when the market was 2400 or 2500 on the Dow and they feel like they're selling their stock too cheap. So there are two sides to the problem.

Senator Riegle. Of course, your firm is somewhat unique in the sense that you have that intense retail relationship with customers and you have a philosophy of selling long- term value. So your orientation is of a very particular kind. I think that may enable you to maintain those investor type relationships more readily than others who aren't as intimately connected as your own firm would be. But I take it then that—you both are concerned, as am I, about damage that's been done here to the capital formation process and further damage that might be done.

Mr. O'Brien. I would put it this way. If it becomes engrained in the minds of people, the sensitivity that prices are not really reflective of value, then I think it will have an unquestioned effect on capital formation—not in the early stages because people don't start up businesses for what will happen 4 years from now, but if that becomes an engrained state of mind, it can have a definite effect.

Senator **Riegle**. Senator Sanford, just to review with you and Senator D'Amato who has just come in and others in the audience, including our subsequent witnesses, as we finish with this panel we will be calling Mr. John Damgard to the table who's the president of the Futures Industry Association, and then we will be calling Bob Rubin from Goldman Sachs and Tom Russo, a partner of another major New York based entity to the table. So do you have anything that you want to raise at this time, Senator Sanford, and then Senator D'Amato?

Senator **Sanford**. I don't want to prolong this because we do have a very busy schedule and I do appreciate the printed testimony, but I have a few issues I would like to raise with this panel of witnesses.

I would like to inquire if in all this studying that has gone on if we've given enough attention to why the stock market was in a situation to fall in the first place. Why was it, as most observers have now said, greatly overpriced in terms of real value? Have we given much thought to the dramatic rise in the market as part of this overall problem?

REASONS FOR OVERPRICED MARKET

Mr. **Bachmann**. I think any time we start assigning the "whys" to things in the market, our answers are imprecise at best. There are a few things to which we can point. Frankly, I have believed that the market was being driven up principally by foreign investment, by people bringing dollars back to the United States. I have read and I believe the Brady report suggested—and I think it has to be viewed as a suggestion because I don't know that we can pin down the facts—that the concept of portfolio insurance may have caused some large institutions to become more bold than they otherwise might have been.

Senator **Sanford**. Or perhaps reckless instead of bold.

Mr. **Bachmann**. Well, I think they thought they were bulletproof and the fact is that it's just like when—I'm from St. Louis—when the Cardinals play the Cubs, the stadium is on the Missouri side of the river for St. Louis obviously and when the game is over every fan thinks that they're going to be back home in Illinois in 5 minutes, all those Cub fans. They all believe that they're going to make it. Only a few can get through. The same thing happened. Everybody thought they were going to be the ones to get through and most didn't.

So I think that there was a false sense of security there. By the same token, there were many responsible observers who believed that the market should be selling at 3,000. I mean they have been saying it and continue to say it today. So it's pretty imprecise.

Senator **Sanford**. My question really went to the overpricing of the market, because predicting that the market should be at 3,000 is a bold statement, to use your word, or maybe a reckless statement. But has any real study gone into whether or not that was part of the problem that could have been perhaps modified in some way? Are there any danger signals as we see it going up as contrasted to danger signals when it goes down rather suddenly? I'm really asking if you think that's been adequately studied.

Mr. **Bachmann**. Well, I think it's studied constantly but I don't know who can make an authoritative study because it is so subjective, so subject to opinion.

Senator **Sanford**. That goes for all the studies and reports we've got before us now. We've got almost too many. Was there any coordination in all these study groups as they set out to find the answer?

Mr. **O'Brien**. I don't think there was any coordination as far as I know, Senator, but as far as studying the question of whether something can be done about the market going up, there was very little asked about the market as it was going up. I guess I've been as large a fool as anybody else and I made a note here—I've been an investor for 41 years and I thought the market was too high in October and most people that I know thought the market was too high, but the question is not whether you think it's too high; it's whether you have the emotional strength or whatever it takes to do something about it; namely, to dispose of all or part of your holdings. Most people I know, other than Mr. Trump, didn't do that.

And I think implicit in one of your questions was whether the increase in the price of that market had something to do with the way down on October 19, and I think it probably did, unquestionably.

Mr. **Schaffer**. Senator, one other thing you might want to know is there were some signals there compared to historical standards. The P/E ratio for the S&P 500 stocks, for example, ran along with the averages that had been held true in prior years. By the way, the same thing was not happening in the lower capitalization stocks on the American Stock Exchange and the over-the-counter market. But that did seem to indicate the market may have been too high.

Senator **Sanford**. Mr. Brady suggested as one of the reasons that the market perhaps was overpriced was because of the hostile takeover mania, that people were speculating more than investing, and I haven't seen that suggestion developed with any particular study and that would be part of my question, too.

Do you think that ought to be looked at a little more thoroughly?

Mr. **Bachmann**. I think everything that could have played a role should be examined carefully. I confess I find it pretty hard to be too convincing on some of these theories that come up afterwards.

Senator **Sanford**. Well, that's true. I've been watching the takeover business with a great deal of discomfort for several years because it seems to me that there are so many side effects that do harm to the economy, transferring equity to debt, dislocating local communities, jeopardizing research and development, and maybe now that it's spread to the banking business, affecting the safety of our banking institutions. The Urban Bank today announced it is looking at an Italian investor, thereby dislocating our regulatory lines, if nothing else, all because of something that had nothing to do with sound banking practices or sound business or maybe even good economics. That seems to me to be part of this problem that we've neglected and I take it that you have indicated you could study it some more.

Mr. O'BRIEN. But I would also caution, Senator, that the reevaluation of market values as part of the takeover phenomenon or not is not intrinsically wrong, and I think that point has to be kept in mind. The reevaluation of the value of properties, equities, etcetera, in my own personal view has benefit.

Now I think that the anticipation of values being raised as part of a takeover phenomenon certainly played a part in the minds of some people, but regulation is not going to and in my judgment should not solve the problem of takeovers or reevaluation of assets in America.

Senator SANFORD. Regulation might very well solve the manner of takeovers. It might very well have something to do with whether or not you take over a company with the mutual agreement or whether you take one over where you then pawn the assets to pay for it in a way that has a bad effect on a number of things, including the total amount of debt held by the company.

Mr. O'BRIEN. That's true.

Senator SANFORD. This is not the main point of what we are discussing, but it is a collateral point and it is an important point. It does relate to legislation now pending before this committee.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sanford.

The distinguished and able Senator from New York, Senator D'Amato.

Senator D'AMATO. Mr. Chairman, it's good to be with you and I want to commend you for calling this hearing. I may not necessarily be supportive of some of the legislative initiatives which seem to attempt to address the problems at this time, but I think it's important that we at least have the opportunity to look at the problems that exist.

I'm wondering, Mr. Chairman, if any one of these panelists or the next panelists would mind addressing a subject which I saw this morning addressed by former Secretary of Treasury Donald Regan. He was quite vociferous. I don't know whether you saw it on the "Today" show. That's that 7 o'clock program that comes on on NBC—I think that's the "Today" show—but it was on channel 4 and I think Jane Pauley was there and that's how I try to keep the "Today" show from the "Good Morning" show, from the "Next Week" show or whatever.

The CHAIRMAN. The Senator from New York appears on all those shows. [Laughter.]

Senator D'AMATO. They call me for comic relief and I enjoy it myself. Mama gets a big kick out of it.

But you should have seen the secretary. I woke up early in the morning to Donald Regan and he was like "I am in command." No, that wasn't him; that was somebody else. But he made this reference—and it's a question that I've raised and wondered about—here we had this $1 billion increase in the trade gap. It went up $1 billion and people anticipated that that margin would go down. And then you had a 100-point drop in the market. And he tied it to the futures industry as it relates to these new products indices dealing with currencies, etcetera. He was quite vociferous. He said, "Look, they're not commodities. They shouldn't be dealt. It's wrong. It exacerbates the problem. People are speculating. It's a speculative fever which is triggering this reaction." I'm going to look for the transcript because I have to confess I turned on the TV and he was already into this—it almost seemed like an Alfonse diatribe.

But I'm wondering, do you have any comments on that? Do you believe that has any merit, the former Secretary's contention that this indeed may be fueling this speculative market that has these kinds of rollercoaster effects on the marketplace? I really want to see what the next panelist is going to say.

Mr. **O'Brien**. Well, I didn't see Don Regan. I saw Jane Pauley a little bit later than you did. So I tend to disagree with what I think you said he said.

Senator **D'Amato**. He said they should do away with the futures as it relates to these instruments dealing with the financial currencies and indexes.

Mr. **O'Brien**. I don't buy that.

Senator **D'Amato**. He said that they are not commodities and what do you get and there's no value, but it fuels the speculative kind of situation that drives the powers of these ups and downs.

Mr. **O'Brien**. Well, I would be skeptical about that, Senator. I know that they've come in for a certain——

Senator **D'Amato**. I'm going to mention to the chairman, Mr. Chairman, I would think that it would be well worth inviting the former Secretary to come in and amplify on that which again I only got a portion of, that he talked about today on that show. I think it might be quite interesting.

Mr. **O'Brien**. The reason I would say that is I think that there is a whole body of opinion which is respectable which is to the effect that the futures serve a perfectly legitimate purpose of hedging on currencies and handling the otherwise irrational imbalances with respect to commodities, currencies, etcetera, on a worldwide basis. So to simply disparage them because of some need for perhaps some adjustment at this time, I'd say the burden is on somebody to prove that, at least to me.

Senator **D'Amato**. He tied it very closely to the currencies as it related to the trade gap when there was a $1 billion trade gap. He said, here you see this $1 billion move in the market and, again, I don't know, but does anybody else have any ideas?

Mr. **O'Brien**. Well, he should go to the Chicago Mercantile and he'll look up there and he'll see the currencies being traded and see a lot of that business—maybe 60, 70, 80 percent of it—is institutional business which is done for a hedging purpose.

Senator **D'Amato**. He was very specific in calling for the elimination of this kind of practice and, again, this is the first person of any stature or authority in this area that I've heard really come out as vehemently and as certain that this was fueling this kind of speculation.

Mr. **Bachmann**. Currency futures?

Senator **D'Amato**. Well, he talked about the futures in these various currencies and these noncommodities. He said, look, these are not commodities. They don't get anything. There's no wheat. He just said this is exacerbating the situation.

Mr. **Bachmann**. If we're going to be truly a world economy—and I can only address the currency—I think American industry, as well as the rest of the world, is going to want to hedge at times when you have these fluctuations between currencies. I have not heard that linked to the events of last Thursday. Part of last Thursday was just sheer nervousness. Investors are very nervous. I think some part of it was due to index arbitrage, but it's pretty hard to sort out how much you assign to one and how much to the other.

Senator D'**Amato**. Thank you, Mr. Chairman.

The **Chairman**. Isn't it also true that it's a thinner market now? I've seen statistics that indicated that it takes a small fraction of what it used to take in buying to move the Dow up one point. It takes an even smaller fraction of what it used to take to move the Dow down. So the volatility is greater on the down side and it's greater on the up side. It's a market that's very vulnerable because of the thinness of the trading and the fact that there are fewer people involved, especially the small investors, that tend to stabilize the market.

Mr. **Bachmann**. It may be that we need to do a better job of sorting out what makes up the volume on the stock exchange. For example, you have these—I would call them—rather bizarre dividend transactions that take place as a result of Japanese tax laws that inflate volume on the stock exchange certain days, and perhaps we need to be able to look at the volume and see what some of the components of that volume are because I think there have been serious misreadings of volume because we don't know how much is proprietary trading by firms, we don't know how much is institutional and how much is retail, how much is foreign. Perhaps some of that would be helpful.

The **Chairman**. To follow up Senator D'Amato's suggestion, wouldn't any prohibition on hedging simply drive overseas the hedging operations? As you stressed several times now, we do have a worldwide market. We have a market that is interdependent in Japan and the United Kingdom and elsewhere. So wouldn't there be a likelihood that people would simply hedge by trading overseas and the overseas markets would accommodate that?

Mr. **Bachmann**. I think there is a strong belief that that would happen. Coming back to the idea of a single regulator, there's almost a sense that if there were a single regulator and it were the SEC that somehow the futures and options would be badly damaged by that. I don't believe that. I believe that it's in the interest of our country and our regulators to see that those activities take place here, but I do think there's a need for some fine tuning and some balance.

The **Chairman**. Thank you, gentlemen, very, very much. You did a fine job.

John Damgard, president, Futures Industry Association.

STATEMENT OF JOHN DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION; ACCOMPANIED BY DAVID GANIS

Mr. **Damgard**. Thank you very much, Mr. Chairman. Let me announce at the very beginning that my new chairman, David Ganis, is in the audience. He's the president of Northern Trust Futures in Chicago, recently elected as chairman of the Futures Industry Association. So to the extent that questions relate strictly to banking, perhaps David could come and join me.

The **Chairman**. Why don't you have him join you up here at the witness table.

Mr. **Damgard**. All right.

[The complete prepared statement of Mr. Damgard follows.]

The CHAIRMAN. Thank you very much, Mr. Damgard.

Mr. Damgard, you indicated that Greenspan and Ruder joined Gramm in saying that they wanted no legislation at this time.

That's not the case. I specifically asked them if they would make specific recommendations. In his testimony Mr. Ruder indicated that there should be a way of settling irreconcilable differences between the regulators. But when I asked for legislation, I asked for it on March 1, and they said they couldn't provide it then. They said they would have it a little later. Before they could respond the administration asked to delay it until May so that they had that pressure from the administration. And when they came up to testify, they indicated in effect that they were going to wait until May.

But there was no indication, none, that either Greenspan or Ruder—either the Federal Reserve Board or the Securities and Exchange Commission—took the position that there should be no legislation.

Mr. DAMGARD. Well, Mr. Chairman, I was basing my remarks on having attended the hearings on the House side before Congressman Markey where it was my distinct recollection that they indicated that legislation may or may not be their judgment at some point and recommending legislation may or may not be their judgment in the future, but at this time they were not recommending legislation. They were joined by Under Secretary Gould at that hearing. As I recall, Chairman Greenspan was not there. And if the record suggests that I'm mistaken, I stand corrected.

The CHAIRMAN. They're not recommending legislation at this time. But that is far from saying that they don't favor legislation. I'm convinced that had the administration not intervened we would have had recommendations before the committee. We would have been well on our way to acting as a committee. The Senate and the House might well be on their way to acting. But the administration intervened and they postponed any kind of recommendation by the regulators until May.

Anticipating this, I specifically asked the regulators not to clear it with the administration because they're independent agencies. There's no reason why they should clear it with the administration and they specifically told me they would not, but then they did.

So the situation is that the administration has stalled the legislation.

MARGIN REQUIREMENTS

Mr. Damgard, you say that the futures exchanges have already responded to the question of margin by raising the level. What is the level now?

Mr. DAMGARD. The level is about 15-percent and, of course, that varies almost on a daily basis because the value of the portfolio stocks in the S&P 500 value varies as well.

The CHAIRMAN. Now that 15-percent applies to not only to brokers but it applies to an investor?

Mr. DAMGARD. Well, from the standpoint of the exchange, that's a minimum. The brokerage firms themselves to their customers may indeed charge anything they want above that level and indeed have.

Testimony of
JOHN M. DAMGARD
President
Futures Industry Association
Before the Senate Committee on
Banking, Housing and Urban Affairs

April 19, 1988

Mr. Chairman, Members of the Committee:

Thank you for the opportunity to appear before you today on behalf of the Futures Industry Association (FIA). FIA is the national, and increasingly international, trade association of the commodity futures and options trading industry. Our Regular membership is composed of over 100 of the largest futures brokerage firms, called "futures commission merchants" or "FCMs." Our Associate and International members, which number nearly 200, include all U.S. and many foreign exchanges and clearinghouses, law firms, accounting firms, and users of the markets, such as commercial and investments banks, and pension, insurance and mutual fund managers. Our membership, though varied, shares one important goal -- the preservation and promotion of well-regulated and efficient futures markets for the transfer of risk and the discovery of price. FIA members believe that the derivative instruments markets are essential to the management of U.S. business and the efficient functioning of the U.S. economy. Testament to this is the remarkable growth of the futures markets in terms of the number of products developed to meet the needs of American business and the five fold increase in volume over the last ten years. These markets have been successfully regulated by the CFTC, with oversight from the Congress, as the markets have moved beyond purely agricultural commodities to providing risk-shifting mechanisms for financial institutions.

FIA members experienced the events of October from a variety of perspectives: as users of the market for managing their own balance sheets, as risk management and trading advisors (including for institutions), and perhaps most importantly, as members of the exchanges and clearinghouses, and therefore the ultimate guarantors of the integrity of the system. It is most important to note, however, that FCMs were and are the link between the futures markets and the public. The public is our constituency, and the positions we take are, we believe, in the public interest.

We applaud the attention that this Committee, and the Senate Agriculture Committee have given to the issues raised by the events of October, 1987. We believe that the studies done by the Brady Commission, the Chicago exchanges, the CFTC, the SEC and GAO have contributed substantially to our general understanding of the markets, how they function and the degree to which they are interrelated.

You have asked me to testify in response to the recommendations of the Brady Commission, specifying what changes should be made in our market mechanism system and suggesting improvements to S.2256, The Intermarket Coordination Act of 1988.

The FIA believes that increased cooperation and coordination among regulatory and self-regulatory organizations (SROs) is essential. There is abundant evidence that great progress is being made in this area. The agencies and their SROs have improved liaison including regular discussions of market emergency contingency plans, information sharing, margins, circuit breaker mechanisms and surveillance. The creation of the White House Working Group adds a note of urgency to these deliberations as a report must be submitted to the President on May 18.

The futures and securities markets have responded quickly to address those areas of concern delineated by Mr. Brady. Therefore, we see little reason to vest an unwilling Federal Reserve Board with additional and duplicative authority. Briefly, in response to Mr. Brady's recommendations that unified clearing be implemented, the exchanges and clearinghouses are moving toward this goal through the routine exchange (by electronic means) of pay and collect data. Initial speculative margins on the S&P 500 futures contract have been increased to $19,000. The CME is committed to maintaining speculative margin at 15% of the value of the contract. Margins on the Major Market Index have been increased to $15,000, which is also 15% of the value of the underlying index. These levels of margin, coupled with the daily marking to market of futures contracts, provides increased protection to the futures clearing system that one does not find when settlement is postponed for five to seven days. Thus, we believe margin levels already are consistent between futures and equity markets as recommended by the Brady Commission. New procedures have been adopted to facilitate intraday margin calls. Price limits have been instituted on index futures at the CME, CBOT and Kansas City Board of Trade, which operate as circuit breakers to slow down the market. These actions, though initially done unilaterally, are now being re-examined by the agencies and SROs in order to rationalize them across all markets, as the Brady Commission recommended. And finally, it should be noted that the futures industry has pioneered development of trade information systems, including risk management analysis and computerized trade reconstruction which is the foundation for the futures industry's superior audit trail.

The FIA, in one of the first meetings with the Brady Commission, recommended the institution of permanent price limits in the futures market. Despite the existence of some negatives associated with the imposition of price limits, the FIA advocated to the Brady Commission the benefits to be derived. Price limits operate as a "natural" trading halt which can be anticipated. Therefore, the cessation of trading is not imposed in an emergency by regulators, but rather happens as a result of the operation and movement of the market itself. Thus, the psychological effect of trading having stopped is diminished and panic selling can perhaps be avoided. The result is that there is time for the market to decompress: buy (or sell) orders can enter the pit to reverse the market; additional time becomes available to arrange for financing; and the payment and collection of margin is facilitated. Most importantly, the determination of the appropriate level of price limits should continue to be made at the exchanges. We also suggested that the Brady Commission give very serious consideration to the imposition of limits in the equity and options markets. As long ago as November, we expressed the grave concern that price limits operating in only one market threaten to destroy the primary function of the derivative market by disengaging it from the cash market.

In light of the progress being made by the agencies and SROs, we agree with Chairmen Ruder, Gramm, and Greenspan that legislation is not needed at this time.

The FIA would not oppose the statutory creation of an intermarket coordinating council. Indeed, we are in agreement with you that there is an urgent and compelling need for Federal regulatory agencies and SROs to work together to produce a more coordinated system for regulating trading of equity and equity related instruments. However, S.2256 raises concerns, particularly with regard to the extraordinary power of a majority of the Committee to direct the Fed, CFTC and SEC to take action.

The Committee structure defeats the role of the Federal Commissions by eliminating any role for the duly appointed and confirmed members of the agencies. In fact, a majority of the Committee can override decisions made by a majority of commissisoners at the respective agencies. Further, the legislation appears not to be limited to stock market related issues.

FIA favors an approach which would continue the work and formalize the structure of the White House Working Group. This group could be required to meet regularly for the purposes of discussing long-range goals of market regulation and structure and immediate concerns of market and financial surveillance. The latter might include sharing of position data relating to credit flows from all markets, enforcement information and auditing information. The long range goals include working toward coordinating circuit breakers and analyzing their potential impact given different market scenarios, analysis of the benefits and detriments of unified clearing with or without cross-margining, technological improvements to increase market capacity and efficiency, standardization of trading requirements, such as net capital and margin across boundaries for users active in many markets around the world, and national and international market emergency contingency planning.

This Working Group would serve as a forum for the discussion and advancement of these ideas and concepts while being fully informed of the activities of all the markets and their participants. We do not believe that authority need be taken from any agencies and transferred to the Committee, nor that any agency should have veto power over the actions of any other agency.

In previous hearings, witnesses have testified to the threat of loss of our markets' preeminence to those located abroad. Right now, the United States has the most liquid and best regulated futures markets in the world. But foreign futures markets, to a far greater extent than foreign equity markets, are extremely well developed and poised to capture the U.S. business. For example, in 1985, the ten most actively traded futures contracts in the world were all traded on U.S. exchanges. Last year, two of the top ten (and the eleventh) were foreign futures contracts: the Yen Bond in Tokyo, the French Bond in Paris, and the Long Term Gilt in London. Tokyo will begin to trade a U.S. bond contract within a year. If we make doing business on the U.S. futures markets too expensive, inefficient, or subject to uncertain or duplicative regulation, you can be assured that the foreign markets will be the beneficiaries. We will have lost yet another U.S. industry to foreign competition and as even the SEC has recognized, business will now be conducted on markets we do not regulate at all.

Our paramount concern is that the CFTC, the expert regulator, retain its full jurisdiction over all futures markets. It is clear that these are complex markets which must be regulated by an agency whose staff understand intimately how the markets function. This is not the time to turn regulation over to well-intentioned but inexpert regulators. It may be the time, however, to formalize the cooperation and coordination of the agencies and the SROs. FIA pledges its support to this undertaking and would be pleased to work further with the Congress and the agencies.

The CHAIRMAN. But the only rule is that it be 15-percent for anybody and if the brokerage firm wants to require more because, of course, the investor may not have the credit rating, it may be higher.

Mr. DAMGARD. I think it's a business decision on the part of the firm. I think that the brokerage firm may feel that their customer is well financed in some other account and, therefore, it's not necessary to require more margin, but I think Merrill Lynch was requiring of individual investors something like $45,000 on October 19 for one lot.

The CHAIRMAN. But there's no floor that has been required by the regulators saying it cannot go below 15-percent in the future?

Mr. DAMGARD. There was a floor required by the SRO, the exchange.

The CHAIRMAN. The SRO can change that at any time?

Mr. DAMGARD. Yes, that's true.

The CHAIRMAN. Now that compares with a 50-percent margin requirement or a 25-percent margin requirement, depending on who you're talking about, for most investors it's 50-percent in the New York Stock Exchange. So that's quite a difference, 50-percent compared to 15, and a 15 that can float downward.

Mr. DAMGARD. And all I can say, Mr. Chairman, and I won't bore the members again, but the functions of the margins in securities and the function of the margin in a future are two entirely different things. As you well know, in a futures margin, people put up margin on both sides and title to an asset does not transfer, which indeed is what does take place in the equity markets. In equities, you're basically talking about an extension of credit on the part of the broker to the customer. And in the futures market, because there's no transfer of asset, there is not an extension of credit.

The CHAIRMAN. I understand that. That is a legitimate difference. Nevertheless, the fact is, on the one hand, if you are investing 50-percent of your own money and on the other hand you're investing 15-percent, 85-percent you borrow, obviously there's a greater degree of speculation, a greater degree of risk, and there's likely to be a much greater degree of fluctuation.

Let me ask this. Mr. Damgard, while the SIA advises that stock index futures be overseen by the SEC, you support formalizing an intermarket council that would make sure that the efforts of self-regulatory organizations are harmonized and not counterproductive, which seems to be mostly in agreement. But you do question some of the powers in my legislation.

Could the futures industry present the committee an outline for legislation sometime in the next few weeks?

Mr. DAMGARD. We would be pleased to for the record submit our thoughts on that, but at the moment we believe that legislation is not necessary and I can't promise you that within the next 2 or 3 weeks we will have decided that it is necessary.

The CHAIRMAN. Well, that's fine. It's a perfectly legitimate viewpoint and I wouldn't say it's wrong. If you think we shouldn't have legislation, that's fine.

Mr. DAMGARD. I think formalization of the White House working group by any name is a good idea and I think probably that can be done in a variety of ways and perhaps legislation is necessary. I'm not certain in my own mind how much power the executive has, as you mentioned earlier, over the independent regulatory agencies. Maybe Executive order does not apply to the independent regulatory agencies, in which case perhaps legislation will be necessary.

The CHAIRMAN. Now in your testimony you recommend that formalization of intermarket issues take the form of a discussion group. The difficulty with a discussion group is that an intractable difference not only affects the defensive party to the discussion but it also affects all other elements of the system that is one market.

How would you settle irreconcilable differences? Just do nothing?

Mr. DAMGARD. Well, I'm not sure. I think that the councils can meet and debate and bring subtle pressures on each other to effect a result without making one party or parties that are inexpert in the other areas' business responsible for knuckling under to the judgment of the other two.

The CHAIRMAN. What's the matter with a majority vote?

Mr. DAMGARD. Because I don't think that you have the expertise at either the Fed or the SEC that exists at the CFTC.

The CHAIRMAN. Well, they're both excellent organizations with tremendous reputations and big staffs and big resources. There's no reason, if given this responsibility, why they couldn't develop their own expertise.

Mr. DAMGARD. Well, for the same reason, I don't think that the SEC and the CFTC should be overriding the Fed's judgment, and I think if they did, then one would wonder whether or not the Board of Governors at the Fed are essentially working for——

The CHAIRMAN. They certainly shouldn't be overriding the Fed's judgment with respect to monetary policy, but we're not talking about that. We're talking about regulatory policy and a regulatory policy in what we conceive to be one market. The situation is chaotic at a time when decisive action and responsibility for those actions are necessary.

Mr. DAMGARD. Nobody has told me, Mr. Chairman, what any other agency would have done that the CFTC didn't do or, for that matter, what any other agency would have done that the SEC didn't do on October 19. So I'm not, nor is my board, convinced that some new mechanism and some duplicative layer of regulation is either necessary or wise.

The CHAIRMAN. Senator Sanford.

FOREIGN COMPETITION

Senator SANFORD. Thank you. Thank you for being here.

Let me ask you about a couple of your statements. You expressed the fear that we might lose our markets 'preeminence to foreign markets if we do anything that we are not doing now, or add any new regulations. You say that last year ten of the most actively traded futures contracts in the world were traded in the U.S. exchanges and two of the top ten are now traded abroad. Why did we lose those?

Mr. DAMGARD. Well, we didn't lose the Japanese bond contract.

Senator SANFORD. I didn't think so. So we haven't really lost anything, have we?

Mr. DAMGARD. Well, the point is that we are no longer the only place in the world that trades futures contracts of sizable volume.

Senator SANFORD. Yes, but it is hardly an argument for your point that the yen is traded in Tokyo and the French bond is traded in Paris, and the long-term Gilt is traded in London. Are we losing or likely to lose any of our futures business?

Mr. DAMGARD. Yes, sir.

Senator SANFORD. Why?

Mr. DAMGARD. In fact, I can give you an example. First of all, the yen currency contract is traded in Chicago. It's not traded in Tokyo but they're just about to start a currency exchange in conjunction with——

Senator SANFORD. Why are we about to lose it?

Mr. DAMGARD. I'm just saying that if you burden the regulatory structure and make it less efficient to do futures business on U.S. exchanges, then other futures exchanges around the world will jump in and fill that void. There's one example, if you'll permit me, that I can make. On October 20, when the Chicago Board of Trade bond contract hit its limit, trading in Chicago was halted and trading in that contract in London on the London International Financial Futures Exchange increased 800 percent.

Senator SANFORD. Are you suggesting we shouldn't have that limit?

Mr. DAMGARD. No. The limit is probably an appropriate limit. What I'm saying is that the exchanges themselves are in the best position to determine what those limits are. These are everyday management tools that managers of exchanges find to be critically important to the orderly running of those exchanges. The point is that when trading stops here it moves somewhere else in the world.

Senator SANFORD. The limits are so important that they ought not to be abrogated just to keep the business.

Mr. DAMGARD. I think that they are set by the managers on a very complicated formula which relates to both the volatility and the liquidity.

Senator SANFORD. Are you suggesting that we lost that business to London because we overregulated?

Mr. DAMGARD. No. I'm suggesting that we lost that business to London because we hit a limit in Chicago. I'm using the example to show that there is a perfectly capable offshore futures market that was able to pick up the extra volume. Absent the limit, that business probably would have been done in Chicago. I believe there were other reasons to justify that price limit, but it is true that there are very viable futures markets abroad that stand to benefit from unwise and unwarranted regulations.

Senator SANFORD. I've argued that we shouldn't put CFTC and SEC together, but I'm not so sure you make that argument here and I simply want to develop it a little bit.

How did it happen in the first place that CFTC got into the securities business and out of the agricultural business?

Mr. DAMGARD. Well, CFTC is really the agency that regulates futures, Senator. When a proposal came along to trade futures on stock indexes, it was sent to the CFTC for its approval. The CFTC consulted with the Treasury and the Fed and the SEC and other agencies, as they always have, in determining whether or not there was an economic need for that futures contract to be traded.

As a result of that, this so-called Johnson-Shad Accord resulted with what's been basically a very fine working arrangement between those two agencies. That isn't to say that October 19 didn't point out that the way in which these markets work together can't be improved, and it also points out that——

Senator SANFORD. Let me ask you this. It's true that the CFTC was dealing in futures but not in securities. Are you suggesting that futures are commodities?

Mr. DAMGARD. Well, Congress decided that, Senator, in 1974 and once again in 1978 and again in 1982, and yet again in 1986. They defined a commodity as any good or service. So the answer is, yes, a future on a stock is indeed the same as a future on a commodity.

Senator SANFORD. Your basic argument, then, is that futures are not like securities?

Mr. DAMGARD. Absolutely. A future is not a security. A future contract provides investors with a mechanism—I should add that most of the people that utilize the futures business are indeed professionals and that's why the number of complaints on October 19th were very, very low in the futures market.

Senator SANFORD. Certainly there is no suggestion by you or your organization that we ought to coordinate SEC activities and futures of corn prices?

Mr. DAMGARD. No, sir. I think that's——

Senator SANFORD. Why not?

Mr. DAMGARD. Well, because the Department of Agriculture is the agency that has responsibility for the underlying cash market in corn. Just as the Energy Department has the underlying regulatory authority in the cash market in fuel and crude oil. CFTC is the expert agency in futures.

Senator SANFORD. But if the Agriculture Department is regulating futures and futures are commodities, why shouldn't the Agriculture Department regulate them all?

Mr. DAMGARD. Well, the Agriculture Department did regulate it all at one point, Senator, and with the advent of——

Senator SANFORD. What I'm really asking, is, didn't the CFTC and the futures industry rather accidentally get into the securities business?

Mr. DAMGARD. No more than we accidentally got into the currencies business or the energy business or any other business upon which futures contracts are based.

Senator SANFORD. At that point, if logical reasoning had gone in at the beginning saying that futures on stock indexes are much more like securities than they are like wheat, would they not have been put under the authority of the SEC?

Mr. DAMGARD. In my judgment, Senator, I think Congress has acted three times very wisely in determining——

Senator SANFORD. As a member of Congress, I must say that I think many have began to question the wisdom of the current regulatory division between the SEC, the CFTC and the Federal Reserve Board.

Mr. DAMGARD. I know. And every time you have determined that regulation by function makes sense. The function of a futures contract is entirely different than the function of a security. A security and a security market is for capital formation and God bless capital formation; it raises money and builds factories and creates jobs. Futures contracts don't do that.

Senator **Sanford**. Wait a minute. Securities futures have nothing to do with raising capital?

Mr. **Damgard**. Futures markets do not raise capital.

Senator **Sanford**. But you said they do not have anything to do with it.

Mr. **Damgard**. Well, what they do is they give institutional managers and firms an opportunity to utilize security markets in a highly efficient manner. Witness after witness has come along and explained how important the derivative markets are to the securities market.

Senator **Sanford**. My time is up. Thank you very much, Mr. Damgard.

The **Chairman**. Senator Riegle.

Senator **Riegle**. I will be very brief, Mr. Chairman. I appreciate the testimony that he's given and I know we have other witnesses waiting this morning.

COORDINATION AND EXCHANGE OF INFORMATION

You mentioned while I was out of the room with respect to coordination between markets in the future that there might be merit, if I'm quoting you correctly, in formalizing an Executive order with respect to the Treasury Department. Am I quoting you properly or is that your view?

Mr. **Damgard**. That is correct. We believe that there would be merit in some sort of a formalization of the current working group, the White House working group. It does include the Treasury Department and the Treasury, I gather, has the lead.

Senator **Riegle**. I take that to mean that you feel in an emergency type situation there ought to be a way to act in a uniform, unified way? Should I draw that conclusion?

Mr. **Damgard**. Well, I think it would depend on the emergency, but I certainly think that far better coordination and exchange of information should be taking place than has taken place in the past.

Senator **Riegle**. Do you hold the view that particularly as large blocks of stock have been accumulated by pension funds and pension managers and other large institutional investors that buy and sell stocks over very short periods of time, sometimes daily, sometimes within a matter of days or a few weeks, that that development—the development of larger and larger volume being conducted by institutional investors with major blocks of stock have helped turn securities, at least in part, into a form of commodity, and that, in turn, has led to the development of a secondary market in futures and options that treat stocks and stock indexes like commodities in part because they are being handled as commodities by very large investment groups?

Mr. **Damgard**. Well, we are in a new era and I think that it's important to realize that the small investor today isn't just part of the 60 percent that was mentioned earlier by Mr. Bachmann. The small investor, more often than not, does indeed have his equity investment in his pension fund or in his mutual fund or through his 401(k) or through whatever other retirement fund that he might have. More and more money is coming into those kinds of funds and they are demanding the most sophisticated kind of management. You find very sophisticated money managers competing with each other for a role in managing those mutual funds and pension funds. They are the ones that are demanding these very highly sophisticated mechanisms for expertise in managing the assets of those funds.

Does that mean that they are like a commodity? I'm not sure. I think what we've seen is a growth of mutual funds and pension funds as a result of savings trends among workers and to the extent that they have the best people running those funds and utilizing sophisticated stategies, that's basically the new world of investment.

Senator RIEGLE. Well, I'm inclined to think the more I study this that with so many blocks of stock now in the hands of institutional traders, whether they're pension management people or whoever, and the emphasis is so much on 90-day results, quarterly performance ratings one against the other, that the movement of blocks of stock or whatever the asset is that's held in the portfolio—and they aren't just stocks, they can be bonds and they can be other things—I think increasingly are taking on a kind of commodity character in the sense of what drives the trading process, what drives even the way in which people react to market dynamics.

So it seems to me that that is an element in the way we have seen these two markets cross-connect and I think become more and more connected, albeit differently under different regulatory structures and so forth. If that's so, it seems to me that that's a secular trend that's probably going to continue and especially because it seems to me the data is showing that the small investor is feeling squeezed out, to some extent is being squeezed out, except through maybe mutual fund participation or pension fund participation, and so you may actually have a self-reinforcing dynamic here.

It seems to me there's an awful lot of churning going on in the market as people are generating trading profits that have nothing to do with the Warren Buffet School of intrinsic value and long-term investing and things of that kind.

So I think we've got to get some kind of a foolproof coordinating mechanism here. I think it's important that the SROs and the different exchanges be talking as they are, but I think we've got to have some assurance that we've got something in place that can work.

Mr. DAMGARD. I couldn't agree with you more. I do think that there's a great deal of self-interest on the part of the affected exchanges, and in this case specifically the New York Stock Exchange and the Chicago Mercantile Exchange, to coordinate their circuit breakers that I'm looking forward to the day when that has been accomplished, recognizing that that's a very difficult thing.

Senator RIEGLE. How close do you think we are?

Mr. DAMGARD. I think we're a couple of weeks away. Mr. Melamed and Mr. Phelan were testifying on the House side last week and there was some expectation that they would be able to announçe a breakthrough at that time. I sense they were both disappointed that they weren't able to. Though I'm not an expert in these markets, I will tell you that these are highly difficult and highly sophisticated mechanisms, making coordination difficult. There inability to reach an agreement doesn't mean that they aren't working very hard at it. The expertise is at the exchange levels, and I will be very disappointed if in the next 2 to 3 weeks we don't see some of these things in place.

Senator **RIEGLE**. Mr. Chairman, if they are within 2 weeks or so of reaching some kind of a cross-market agreement here, I think that would be a very constructive development and let's hope that's right. Thank you.

Mr. **DAMGARD**. I should hasten to add that I have no inside information.

The **CHAIRMAN**. It's been more than 6 months, and I think that's much too long. I doubt very much if they're that close on anything other than circuit breakers.

Senator Graham.

Senator **GRAHAM**. Thank you, Mr. Chairman. I'm sorry that I was not able to hear the full presentations thus far this morning.

The concern that I have is that we have a recurring pattern of apprehension about new technology, whether it's the hardware technology that the Luddites wanted to beat up back in the 18th and 19th century or the more sophisticated software technology such as the sophisticated techniques and mechanisms in the securities and commodities markets which are causing great anxiety today.

NEW TECHNOLOGIES, TECHNIQUES OR STRATEGIES

What do you think from the perspective of the futures 'industry ought to be the agenda of legitimate public concern to see that we don't inhibit new technologies, techniques or strategies, but that those new departures do not end up essentially disserving the very purposes for which we have an organized capitals and commodities market?

Mr. **DAMGARD**. Well, that's a concern that we share as well, Senator. We believe that the Congress has a duty and indeed every right to be deeply concerned about this and I personally believe that it's been the activities of this committee and others that has spurred the institutions themselves on to resolving such problems as coordinated circuit breakers at a rate faster than they ordinarily would.

At the same time, we are concerned that nothing be done in haste even though well-intentioned that would somehow make these markets any less efficient. We are the envy of the world as far as futures markets are concerned because we have free markets; nobody shuts our markets down for a week. Hong Kong will spend probably the rest of this century trying to recover from the reputation that they now have that it's an unsafe place to put your money. We would hate to see the reputation of U.S. markets suffer by legislation or by unwise regulation that would cause the investor to lose confidence. And I must say that I think what's been done so far has been very appropriate. I share the chairman's concern that it doesn't seem to be going as fast as it should, but I recognize that these are very, very difficult problems. Certainly we owe a great debt of gratitude to former Senator Brady and the other gentlemen that served on his task force for identifying the areas of concern. I believe that the exchanges themselves are working very, very hard to address those and I think that once those challenges are overcome by the SRO's, we can take some comfort in knowing that we will not have another 508 point drop. We can't have another 508 point down day in the futures markets now because we do indeed have price limits.

The concern that we have is that futures markets could be at this moment, disconnected from the equities markets. So if you coordinate those circuit breakers at some reasonable level—and once again, I don't think there is any better place to determine what that limit should be than the exchanges themselves—then I think we will have avoided a day like October 19 and then we can proceed from there to determine whether or not there are any other concerns that require legislation.

I think a lot has been done by the banks. Certainly a lot has been done by the brokerage firms. At the moment, it seems to me that the critical thing is the coordination of these circuit breakers. I at least will have comfort at that point that we aren't looking at any disasters.

Senator **Graham**. I'd like to move that statement to another level just as we did not succumb to the entreaties of the Luddites to go and beat up the machinery there was a parallel concern about child labor in those factories using that machinery which we did respond to as a society because we recognized that there were some values that transcended immediate economic returns. It was economically advantageous to use children in the textile factories. That's why they were there. It took public policy to say that there were some higher values that should limit child labor.

To go to the question that Senator Riegle was asking, a concern that a number of us have expressed is that how does the issue of facilitating the securities and commodities market fit into some broader economic goals such as encouraging a longer range perspective of economic rewards, moving investment away from a lottery concept and a casino concept toward a building of long-term productive values within our society? Are there any public policy items that you think we should have on our agenda to address that relates to the role of the securities and commodities market in those larger economic objectives for America?

Mr. **Damgard**. Well, I would like to say that we're very proud of the futures markets and we believe that the futures markets have been able to complement the securities markets in their capital formation function. I think that every chief executive officer of a securities firm will tell you that the way that they're able to take down these big blocks of stock, whether they're new issues or whether they're trades, at very low risk is because there's a very liquid derivative market in which they can hedge. It's the same way that the primary dealers go to the Treasury Department and bid for our debt. The Japanese, who saw how efficiently we manage our debt, started a government (yen) bond futures market of their own. I think that innovation is something that we want to make certain continues and that there's still room for innovation in our markets.

By the same token, I think we all wonder whether or not technology is moving on so quickly that, as Mr. Bachmann said earlier, the firms themselves have a difficult time utilizing it. Certainly with CRT screens and computers and telephones, information is now instantaneously available around the world.

We have more and more money concentrated in mutual funds and other pooled investments which indeed do represent the little guy, if you will. No one wants to risk their position as one of the managers of a fund by saying, well, I know that the underlying stock has value so I'll just sit on this while it goes down even though my trading record will not be as good as the next guy. He is competing with other fund managers and he wants to be able to take advantage of all this information and all the various techniques that are now being utilized to manage that money as well as he possibly can. I think it's a harsh judgment to say that this is a casino mentality. I think it's just extremely highly sophisticated money management. Further, I suspect that we may indeed be looking at a time where a 100 point move in the market could be close to the norm.

The CHAIRMAN. Thank you, Senator Graham. Gentlemen, thank you for highly competent testimony.

Our final panel includes Robert Rubin, Partner and co-chief operating officer of Goldman Sachs; and Mr. Thomas Russo, who is a partner of Cadwalader, Wickersham and Taft. We will start with Mr. Rubin.

STATEMENT OF ROBERT E. RUBIN, PARTNER AND COCHIEF OPERATING OFFICER, GOLDMAN SACHS & CO.

Mr. RUBIN. My name is Robert Rubin. I'm a general partner, covice chairman and cochief operating officer of Goldman Sachs & Co. Goldman Sachs is a registered investment banking firm, a registered securities broker- dealer and a futures commission merchant.

I have submitted a written statement. What I would like to do is simply emphasize certain portions of it.

The CHAIRMAN. We appreciate that and if you could confine your remarks to 10 minutes.

Mr. RUBIN. I think they will be less, Mr. Chairman.

The CHAIRMAN. They will be printed in full in the record.

DERIVATIVE INSTRUMENTS

Mr. RUBIN. We have the view that options and futures on stocks, derivative instruments, and on debt instruments, greatly and in my opinion critically enhance the ability of market makers to handle the large transactions that have become routine in a world where equity and debt markets are dominated by institutions, and individuals represent a relatively small portion of those trading.

Derivative instruments thereby contribute meaningfully to the efficiency of markets and minimize the cost of raising capital.

We are a major market maker in debt and equity instruments, stocks and bonds. I find it hard to imagine that we could handle the kinds of flows and the demands that institutions make on us in any sort of an effective or efficient fashion without the use of derivative instruments.

Therefore, we feel equity and debt derivative instruments should be viewed as things that are here to stay and things with a very great social utility.

On the other side of the ledger, there obviously is the question of whether stock index futures have exacerbated volatility in the stock market and the question of whether there is risk of a failure or other problems in the clearing system. We view the latter as a particularly serious question. Is there a risk to the markets and, for that matter, to the economy that derives from a possible failure, or at least problems in, the clearing system with respect to futures or less likely stocks?

As an aside, we'd like to observe that in our view at least heightened volatility is almost surely likely to continue without regard to the question of whether futures exacerbate that volatility because of the fundamental factors which you are as familiar with as we are—the trade deficits, LDC loan problems, the budget et cetera.

In the past several months the regulators and exchanges have been exceedingly active with respect to stock index futures and related instruments and the issues that have arisen with respect to them. A number of measures have been taken which I have listed in my written statement. I won't repeat them here other than to mention three that seem to us particularly significant.

PRICE LIMITS ON STOCK INDEX FUTURES

The Chicago exchanges have chosen to impose price limits on stock index futures which we view as a constructive measure. A analogous measure, now being discussed, is to have a market stop on the New York Stock Exchange for stocks if markets fall by a certain amount. I would have many more questions about this. Parenthetically this is my personal view rather than that of Goldman Sachs. I think, on balance, it's probably not a wise thing to do.

MARGINS HAVE BEEN RAISED

Second, initial margins on U.S. index contracts have been raised, which we think is a sensible thing to have done. And third, the Chicago Mercantile Exchange has implemented a system of intraday margin calls which we think is constructive. As I say, there are a number of other measures that are listed in my statement and I won't repeat them here.

We as a firm have been very active with the regulators and with the exchanges. We intend to continue being so.

Having said all that, there are still many issues under discussion. We'd like to comment on a few of them.

We think, as we know you feel, that effective coordination is an absolute must in a world in which stocks and stock index futures interrelate so closely and that is true both during times of emergency and on an ongoing basis.

We also think—and this is a rather technical point, but we think it's a very important point—that member firms of different clearinghouses should be able to move margin from one clearinghouse to another thereby reducing strain on the banking system and, we think, reducing the chances of an accident in the clearing system. I'd like to repeat something I said earlier. I think what I would focus on in these hearings is a failure in the clearing system because, if the clearing system fails, the ramifications for the economy would be not inconsiderable. As a matter of fact, they could be quite unpleasant.

Senator RIEGLE. May I just ask a question on that point?

Mr. RUBIN. Let me add I'm not an expert in the clearing system.

Senator RIEGLE. Well, I don't necessarily assume that you are, but is your concern that what would happen is that the system would jam and in fact transactions could not be closed out, or that you would overrun the capital of somebody who's in the clearance process and you would have sort of a cascade of financial failures?

Mr. RUBIN. The latter it seems to me, Senator, is the most serious concern. If you have an enormous decrease in the market and marks to the market then go out to a lot of participants and they don't have sufficient capital to meet them, the clearing system will then not have sufficient capital to meet its other obligations. You will then have the problem that you just raised which is a cascade of financial failures.

Senator RIEGLE. I almost wonder if we should—I mean that's the clearing system, but it's really I think when you say clearing system it implies a paperwork breakdown, you're really talking about a capital insufficiency here and that may help us get onto the question of what's the capital insufficiency problem that you're worried about. But I've taken enough time now.

Mr. RUBIN. I think you have reframed the issue that I was concerned about very effectively. That is exactly the issue I was trying to raise.

Initial margins on futures is another issue that has been much discussed. As you know, high margins deter activity and, by deterring activity result, in less activity and less liquidity and less efficiency. On the other hand, higher margins are a safeguard with respect to the very problem we were just talking about because they prevent people from participating who do not have adequate capital to meet margin calls under adverse market circumstances.

I do not have a view whether margins at the present time are sufficient or insufficient, whether they are too high or too low, but we do think, as I think John Phelan testified here, that the question of margin levels is worthy of serious study.

Circuit breakers have been much discussed. My own view and I guess it's our view is that circuit breakers have a nice, simplistic sound to them with respect to problems of volatility, but I think they give rise to the very real possibility of unintended and undesirable consequences. As a consequence, I think they should be used as a last resort and with great reluctance.

Having said that, I think the New York Stock Exchange 50 point rule that I think Senator Riegle referred to before is probably, on balance, a good one. I personally think, although there are different views within our firm on this, that stopping trading on the New York Stock Exchange if it falls by 250 or 300 points probably has more bad effects than good effects.

Finally, there's a question of international markets. Clearly our markets are linked to international markets and at some point it seems to me there ought to be some consideration given to trying to get some kind of coordination there.

There can be no guarantees against market instability up or down. We think greater volatility will be the experience of the years to come even without factoring in the effect of futures.

We think, on balance, futures probably are helpful with respect to volatility because they enable market makers to function more effectively. Let me close with a word about S. 2256. It deals with the very issues that the exchanges, the clearing organizations, the regulators, the presidential task force have been addressing. We believe that Senator Proxmire's summary of the purposes of the bill in the Congressional Record is thoughtful and provides a very useful framework for these issues. The only question in our minds is whether legislation is required now.

In view of the work that is going on, the tremendous complexity of the issues, the experience and expertise of those currently addressing those issues, and the possible disadvantage of the new regulatory body, in our view, the best course would be to wait until Congress has a chance to see the outcome of all this activity before deciding whether to legislate.

Hopefully, the next few months will provide a much better sense of what will be done and Congress could then decide whether future legislation is necessary.

Finally, if Congress were to decide no legislation is necessary, we think it might still be useful to require a status report from the regulators and they, in return, from the exchanges and clearing organizations at some point in the future to be sure that focus on all these issues does not diminish over time and to encourage review in light of the then existing conditions.

Thank you.

[The complete statement of Mr. Rubin follows:]

STATEMENT OF ROBERT E. RUBIN

PARTNER AND CO-CHIEF OPERATING OFFICER

OF

GOLDMAN, SACHS & CO.

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

APRIL 19, 1988

My name is Robert E. Rubin and I am a general partner, co-vice chairman, and co-chief operating officer of Goldman, Sachs & Co. Goldman Sachs is an investment banking firm registered as a securities broker dealer and futures commission merchant.

We are pleased to have this opportunity to appear before the Senate Banking Committee. The market collapse of last October has resulted in much discussion and debate about the economic contribution of stock index and debt futures, the impact of these futures and other factors on volatility, the financial integrity of the clearing and settlement systems, and various possible measures with respect to all of these matters.

Our view is that options and futures on stocks and debt instruments greatly and maybe even critically enhance the ability of market makers to handle the large transactions that have become routine in a world where equity and debt markets are dominated by institutions, and thereby contribute meaningfully to the efficiency of markets and to minimizing the cost of capital raising. Moreover, these derivative securities enable investors to manage risk more flexibly, and thus encourage investment in equity and debt instruments.

On the other side of the ledger, however, there is debate firstly as to whether futures contributed to the market demise last October, and secondly as to whether we should be reassured because the futures clearing system didn't fail or concerned because some observers feel the system came fairly close to failure. Without expressing any conclusions on these questions, we do believe that they and related matters warrant very substantial focus.

The over-riding challenge with respect to derivative securities is to preserve the benefits while minimizing the likelihood that their use exacerbates stock market volatility or creates financial problems in the clearing system.

As an aside, we also note that we believe that heightened volatility is probably

The **CHAIRMAN**. You apparently have no fear that in the long run we're all dead.

Mr. **RUBIN**. I'm inclined to think we probably are, Senator.

The **CHAIRMAN**. It would take a long time to do all those things. Mr. Russo, go ahead.

STATEMENT OF THOMAS A. RUSSO, PARTNER, CADWALADER, WICKERSHAM & TAFT

Mr. **RUSSO**. Thank you very much. I would like to submit my testimony for the record and I will just try to do a very brief summary of it.

My name is Thomas Russo. I'm a partner of Cadwalader, Wickersham and Taft. I was with the SEC. I was also with the CFTC as the first director of its Division of Trading and Markets. I have coauthored a textbook on securities law and a treatise on commodities law.

That may sound like I know what I'm talking about, but I may dissuade you of that.

AN IMPORTANT FIRST STEP

I believe that the Intermarket Coordination Act of 1988 is a very important step. It's a first step. I was very impressed with the Brady report. That report, which was done in 60 days, was extraordinary. It's a credit to Nick Brady and to the staff that he assembled.

I think the Intermarket Coordination Act simply puts into effect what was suggesting in his report. The topics treated in the bill are the topics that he dealt with in his report in the recommendations section. It is, in a sense, chicken soup. It can't hurt. It's forcing three significant regulators to work together within the framework of their own statutes and if that framework is not working it is simply saying come back to Congress and Congress will listen to you and make whatever changes to the act that may be necessary.

So I think the idea is a good one and I don't see that it's necessary to wait. I think that much has happened since October. Much has been very positive. The fact is that people are working together now and I think to see Leo Melamed and John Phelan sitting side by side working together is something I might not have thought possible 1 year ago or even 6 months ago. I think that the clearinghouses are beginning to work together. The exchanges are working together. But I think that it's possible such cooperation is temporary.

The fact is that the bottom line of the Brady report was correct—these markets are one. If you believe that, a lot follows from it. It means that the regulators of those markets have to work together.

In my prepared testimony I deal with some of the specific points. I will try to limit this summary to two or three major points.

I agree with Bob Rubin in terms of clearing. Clearing in the bill is listed as No. 1 in importance. Clearing was very important in the Brady report and clearing requires a great deal more work. Clearing is many things to many people, but it deals with the financial integrity of the market. Right now we have different mechanisms of clearing. Though each clearing house works in different ways, they deal with the same fundamental problems. For example, we have one clearinghouse, the largest clearinghouse, that has no assessment powers. We have the second largest that has assessment powers. We have gross clearing systems and we have net clearing systems. We have scenarios where even the trained practitioner in this area is not certain regarding who is liable should a clearing house fail. We have an incentive because there are different clearinghouses for people to grab money first in the form of original and variation margin and share important information second. It's because you have your own self-interest to deal with.

We have a lot of issues which are unanswered and it seems to me that a coordinated effort in the clearing would be worthwhile. It would also deal with many of the issues that are still unresolved, including cross-margining which I think is a very important issue because it deals with the liquidity of the marketplace.

One area that I mentioned in my prepared testimony, which I think I have not heard, and I think is a good example of a lack of coordination deals with hybrid instruments. We are in a situation now where it is confusing whether something is a futures contract. People are getting sued today because they do something which they didn't know was in the realm of the CFTC because it seemed like it might have been a certificate of deposit at the time and they find out that it's a commodity option.

People are trading in markets now, very big markets, trillion dollar markets in the swaps area and people might have thought that this was subject to the SEC or to the securities laws or to the banking rules, only to find that there is an agency out there, the CFTC, thinking that some of these instruments may be futures.

We are in confusion because we have different regulatory bodies looking at the same thing through the eyes of their particular statutes. So long as we have one market, either you put all those regulators together in one agency or alternatively you have a formal mechanism to make sure that they work together. Absent that formal mechanism, there is going to be confusion; there are different constituencies involved; and even though people are working together which is certainly worthwhile today, I don't have any confidence that it will continue down the road.

Finally, I mention in my testimony the manner of trading. The manner of trading in the commodities area and the securities area is different. I think one of the things that should be studied is the benefits that you might get from either the commodities or the securities area so that it could be utilized in the other area. I an thinking specifically of block trading which I think would be very helpful to have on the floors of the commodity exchanges without the worry about the enforcement action because some might consider it a prearranged trade.

Thank you very much.

[The complete prepared statement of Mr. Russo follows:]

here to stay due to the increased pace of events, improved communications, and the destabilizing economic circumstances afflicting us and likely to continue doing so (e.g., U. S. fiscal and trade deficits, LDC loan problems, and disruption in oil and other commodities).

As you know, over the past several months the regulators and the exchanges have been exceedingly active in these areas, and significant changes have occurred or are occurring, including:

- the securities and futures exchanges and clearing organizations have agreed to share certain margin "pay and collect" information on clearing members;
- price limits have been imposed on most index contracts (which we favor, as opposed to limits on the underlying stock market, which in our view may not be wise);
- initial margins on all U. S. index contracts have been raised;
- clearing member financial standards have been strengthened;
- specialist capital requirements have been raised;
- improvements have been scheduled in the stock exchange's order entry system;
- securities clearing houses are exploring position reporting and other tools to monitor concentrated positions;
- the CME has implemented a system of intraday margin calls, and the Board of Trade has proposed additional margining procedures; and
- banks and clearing organizations have met to confirm their payment obligations.

We at Goldman Sachs have actively participated with the regulators and the exchanges in developing these changes and we intend to continue our participation.

Notwithstanding all that has been done, there are still many issues under discussion, and we would like to comment on a few of them.

1. The exchanges and clearing organizations must develop effective communications on a wide range of issues, including market closing and other plans during times of emergency and "pay and collect" information (i.e., the financial position of clearing members) on an ongoing basis. Right now, a customer may have a fistful of cash and a pocketful of unpaid bills, but a futures clearing corporation may see only the cash and DTC (through which stocks are settled) only the unpaid bills. I gather that the exchanges and clearing organizations expect real progress in these areas.

2. Another aspect of coordination is that clearing members of different exchanges should be able to direct funds due from one clearing house to meet a margin call by another clearing house, thereby reducing strain on the banking system and increasing efficiency.

3. Initial margins on futures are a critical issue. On the one hand, high margins discourage participation and reduce liquidity. On the other hand, they increase safety by screening out participants who do not have the ability to meet margin calls under adverse circumstances and by increasing the capital in the system. We do not have a view as to whether today's increased initial margin requirements on futures exchanges are too high, too low, or about right, but we do think this is a matter worth serious consideration.

4. Circuit breakers may seem a simple response to the problems of volatility, but in our view there are many adverse unintended consequences from mandated limits on market moves. Despite these reservations, we feel the newly imposed limits on equity futures, and the New York Stock Exchange rule prohibiting use of DOT for index arbitrage after a 50 point move, may on balance be desirable, though good arguments can be made to the contrary.

5. Stock and debt markets outside of the U.S. clearly are much affected by and much affect our own stock and debt markets. Moreover, equity and debt futures markets are developing around the world. Thus, we feel there should be formal international coordination with respect to the same matters that require domestic coordination.

There can be no guarantees against major market instability up or down. The object, in our view, should be to minimize the likelihood that market instruments will in some way exacerbate those moves, and minimize the likelihood of clearing system failures that affect the financial markets and the economy.

We also feel, very emphatically, that all of the issues I have mentioned, plus many others that are currently the subject of this debate, are very complex, do not lend themselves to simple solutions, and should be resolved only after carefully determining all possible unintended effects. Then, benefits of each particular proposed restriction can be balanced against the adverse impacts, if any, on market liquidity and market efficiency.

Let me close with a few words about S. 2256. It deals with the very issues that the exchanges, clearing organizations, regulators and Presidential task force have been addressing. Senator Proxmire's summary of the purposes of this bill in the Congressional Record provides a useful framework for these issues. The question is whether legislation is required now.

In view of the work that is going on, the complexity of the issues, the experience and expertise of those currently addressing these issues, and the possible disadvantages of a new regulatory body, our view is that the best course would be to wait until Congress has a chance to see the outcome of all this activity before deciding whether to legislate. Hopefully the next few months will provide a much better sense of what will be done and Congress could then decide whether future

legislation is necessary.

If Congress decides that no new legislation is necessary, we think it might still be useful to require a status report from the regulators, and they in turn from the exchanges and clearing organizations, at some point in the future, to be sure that focus on all these issues does not diminish over time and to encourage review in light of then existing conditions.

Thank you.

STATEMENT OF THOMAS A. RUSSO, ESQ. BEFORE THE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS OF THE UNITED STATES SENATE

April 19, 1988

My name is Thomas A. Russo. I am a partner at the law firm of Cadwalader, Wickersham & Taft in New York City, where my practice centers on commodities and securities regulation. I was a staff attorney at the Securities and Exchange Commission from 1969 to 1971; and, during the mid-1970's, I served as Deputy General Counsel of the Commodity Futures Trading Commission and the first Director of that agency's Division of Trading and Markets. I have co-authored a text on the regulation of securities broker-dealers and a treatise on commodities regulation, and I have lectured and written numerous articles on related topics.

I am pleased to be here at the invitation of this Committee to testify about financial markets structural issues. I believe these issues are just as important now as they were during the week of October 19th. We must therefore take full advantage of this window of opportunity to review the regulatory framework governing our financial markets and to make needed improvements.

As we do so, however, we should remember that the world is shrinking and that financial transactions can be driven offshore by regulatory actions or omissions. If our markets are not strong and efficient, trading and underwriting activities can move abroad. A delicate balance must therefore be struck between strengthening our markets, particularly in the area of financial integrity, without discouraging their growth and full utilization.

In my view, the Brady Commission Report was an important first step in the right direction. The bill proposed by Chairman Proxmire, the "Intermarket Coordination Act of 1988," is a logical next step in the effort to address the weaknesses in our financial markets identified by the Brady Commission Report. I strongly support the principal feature of that bill, the apppointment of a formal Intermarket Coordination Committee ("ICC"), composed of the chairmen of the Fed, SEC and CFTC, that would coordinate intermarket regulatory policy and give the chairman of the Fed, as chairman of the ICC, the power to cast the deciding vote in the case of disagreement between the SEC and CFTC.

The bill directs the ICC to prepare legislative or regulatory recommendations to achieve a variety of important reforms, specifically: (i) intermarket coordination of clearing and settlement systems; (ii) harmonized margin requirements across markets to control excessive speculation and financial leverage; (iii) the establishment of circuit breaker mechanisms; (iv) the enhancement of information systems; (v) coordinated contingency planning for emergencies; (vi) effective methods for detecting and prohibiting intermarket frontrunning; and (vii) international coordination of intermarket concerns. The relevant regulatory agencies would be directed to implement ICC decisions in these areas or, if legislation is necessary, the ICC would make legislative recommendations to Congress. In my brief remarks, let me address certain of these topics, as well as a few related issues.

Clearing. I believe the multiple clearing and settlement mechanisms used in the financial markets are the subject most in need of attention. It is true that some significant steps have been taken since last October to improve the existing clearing mechanisms. For example, progress has been made in the area of information sharing. However, separate clearing systems for each principal segment of the financial markets continue to exist: several for stocks, another for options on securities, and numerous others for futures and options on futures. While differences among various instruments, including differing methods of settlement, need to be considered by the ICC in connection with moving toward an integrated clearing system, these differences only partially explain the diffusion of responsibility and attendant inconsistencies under the current system. For example, most futures exchanges have their own affiliated clearinghouses, even though in general each performs the same function of standing between the parties to a trade and bearing the credit risk involved in transactions in futures and options on futures contracts traded on the related exchange.

This necessarily means that each of these clearinghouses has a vested interest in receiving margin payments before the other clearinghouses, especially in volatile markets. If, for instance, information about the deteriorating financial condition of a member firm becomes known to a particular clearinghouse, it will make every effort to assure that it is not the second or third in line to collect funds from that firm. Should a payment default in fact occur, a clearinghouse lacking information will have far greater difficulties than the clearinghouse that is aware of the difficulties early on and acts quickly to seize available assets and levy assessments on its members to fund defaults. Similar potential problems exist in the relationships between the clearinghouses and the banks that they use in connection with performing the clearing function.

In addition, under the current balkanized clearing system, each clearinghouse cannot easily assess the overall financial condition of its member firms and may take precipitous action based upon an incomplete picture of the overall risk position of a member firm. Such an outcome could have unfortunate ripple effects on other market segments in which the firm is also a participant.

A single, common clearinghouse similar to The Options Clearing Corporation, which exists for securities options, would solve these problems in the futures industry. However, because each futures clearinghouse has a separate budget and staff, there is a strong self-interest in perpetuating autonomous clearing mechanisms. Also, to be fully effective, a unified clearing system in the futures industry would need to have appropriate linkages with clearing mechanisms in the securities industry. In the case of financial instruments, in particular, the products are often essentially fungible, whether they are SEC or CFTC-regulated instruments. And, even where the products themselves are not fungible, the major participants in the securities markets tend to be important players in the futures markets and vice-versa, so their financial strength is relevant to the integrity of the clearing process in both market segments. It is only sensible that an integrated clearing mechanism for the financial markets be positioned to assess and manage the overall risk of the positions of the participants in each market segment.

Although the benefits of an integrated clearing mechanism seem obvious for what has become a single, interrelated market, they are unlikely to overcome self-interests that favor maintenance of the status quo, absent strong direction from Congress. As a result, I would go so far as to require the ICC to develop a specific plan to implement a common clearing system. The ICC also could be required to report back to Congress with a proposed blueprint for such a system within a specified time frame, with hearings to be held on that blueprint. Unless the ICC is directed to proceed along these lines, I am not optimistic that meaningful progress will be made in this area.

Cross-Margining. Related to, though separate from, a common clearing system is the issue of the method of margining

similar financial instruments. The current system often does not recognize the reduced risk of hedged positions involving related products subject to SEC and CFTC jurisdiction. As a result, firms must maintain a substantially larger amount of margin with the different clearinghouses than is warranted by the overall level of risk arising from the positions, which adversely affects the liquidity and efficiency of the markets. By contrast, permitting the risk-reducing effects of offsetting positions assumed in other markets to be considered for margin purposes would enhance the integrity of the financial markets.

The Brady Commission Report endorses the concept of cross-margining, a position I believe is the correct one, even though some have argued that cross-margining may impair the financial integrity of the system by reducing the level of margin required for intermarket hedged positions. Indeed, I believe the events of October demonstrate that offsetting hedged positions are more likely to provide enhanced financial security than the current system, under which firms must set aside or "sterilize" significant amounts of cash to meet margin obligations on such positions, which exacerbates the liquidity pressures that are especially acute during periods of extreme market volatility.

The CFTC has been considering a petition to permit cross-margining for more than two years, without making as much progress as one might have expected, given the length of time that has elapsed and the fact that extensive discussions occurred prior to filing of the petition. The SEC, on the other hand, The **Chairman**. Well, thank you, gentlemen, very much for your testimony.

Mr. Russo, the SIA has recommended that the legislation to adopt regulation to the new realities of the marketplace place the SEC in charge. You endorse the approach we have in the bill that several of us have introduced with the SEC, the Fed and the CFTC.

Would you discuss the merits and costs of these two approaches to intermarket regulation?

PROS AND CONS OF INTERMARKET REGULATIONS

Mr. **Russo**. At one point thought it made a lot of sense to put it all in the SEC and I have come around over the last couple of years to change my view on that.

There are a lot of similarities. We can argue that a future is very different from the underlying securities, but the people who trade these are in both markets. So you could say it should be under one agency, but the problem is that under the SEC a lot of innovations wouild never would have been permitted to happen. I remember back in 1973 when the Federal Home Loan Mortgage Corporation thought it would be a good idea to have futures on mortgages and there was a submission made to the SEC for this and the SEC thought it was impossible and it never moved forward. And it was the Federal Home Loan Mortgage Corporation and others that got involved in the 1974 legislation which changed the definition of the term commodity.

Many of the innovations which have happened in our financial world really have come from the futures industry and the CFTC has been actually fairly accommodating in this area. So I think that there's a lot to be said for keeping them, keeping their philosophy, and the innovation that has come. I think on balance there are enough differences to justify two separate agencies, yet there are enough similarities to force a mechanism to have cooperation.

The **Chairman**. You agree with us that that triumvirate should be able to decide irreconcilable differences by a majority vote so there would be a basis for a decision?

Mr. **Russo**. Yes, I think that's the way it should be.

The **Chairman**. Mr. Rubin, you say in your testimony that such problems as developing country debt and fiscal and trade deficits and oil disruptions are going to be with us for some time and they cause volatility.

Shouldn't we make every effort to strengthen our stock market mechanisms because of this turbulence over which we have no control?

Mr. **Rubin**. Well, Senator, I guess my view would be that volatility is the function of the various kinds of factors I mentioned, plus many others. I think if there are things that one can do that would help reduce volatility which don't have other effects that are undesirable, that would be a good thing to do. I think what has really created the heightened volatility, aside from the change in fundamentals, is that the investing perspectives, as I think one of the Senators suggested, of most institutional investors are shortened and shortened and shortened and I think there are all kinds of reasons for that. I think it's the combination of future shock and the real world plus the shortened investment perspective of institutions that have caused volatility.

I think in dealing with stock index futures and the possible impact or exacerbating impact on stock market, I think there are some things possibly that would be helpful there.

The **Chairman**. Let me give you an example of what really worries me. I understand the studies we have show that in the 4 months before the crash it took $2.5 million per 1 percent of the Dow Jones Index to move it 1 percent up. In the 4 months since then, it's taken only $1.5 million. On the down side, before the crash, $1.4 million would move the Dow down one point and now $612,000 will move it down one point.

That kind of volatility that we shouldn't wait. Of course, I'll be an outside observer next year and I won't have anything to say about it. That's one reason why I'd prefer that we take action now.

Mr. **Rubin**. Well, that wasn't my reason for suggesting that.

The **Chairman**. I hope not.

Mr. **Rubin**. I live in these markets every day and I think your point is absolutely right. There's a lot less liquidity. I think it's very troubling if you lived where I live. On the other hand, nothing that I've heard is really responsive to that problem. I think people are frightened by what happened on October 19. I think if you go back over the history of commodity markets particularly, you will find that when there are very large market breaks markets tend to be relatively illiquid and relatively volatile for some period of time. I think it's the nature of markets.

I don't think there's anything you can do by legislation or regulation that's going to have a major impact on that, Senator.

The **Chairman**. You seem to disagree with the reports made by the Brady Commission, by Former Attorney General Katzenbach, by the SEC, all of whom recommended that we take action.

Mr. **Rubin**. No, I didn't mean to suggest that. I think it is very useful.

The **Chairman**. Sit around and maybe if we do something, do something some time in the distant future.

Mr. **Rubin**. No. I think it is very important that action be taken to strengthen the financial integrity of the clearing system so that we don't have the kind of domino or possible domino effect.

The **Chairman**. We've had 6 months. Isn't that enough?

Mr. **Rubin**. Well, I've given some thought to this, Senator, and although I'm not an expert, I think we have very complicated issues. I gather that the view is that something will be coming out by the end of May and I guess my view would be to wait until we see what comes out.

The **Chairman**. Well, we had testimony by the SEC. They conducted an intensive investigation.

Mr. **Rubin**. I think the financial integrity of the clearing system, I think the possible exacerbating impact of stock index futures are matters that I agree within Senator Brady's report. I think those matters need to be addressed. I also think they are very complicated and I personally at least would be inclined to wait until these expert bodies have come up with their views.

Having said that, I think that there are limits to how much you can do legislatively or in a regulatory fashion to deal with the kinds of volatility and problems that we have in our markets.

The **CHAIRMAN**. Senator Sanford.

Senator **SANFORD**. Thank you both for being here.

Let me ask a couple of questions to give you a chance to elaborate a little bit.

CLEARANCE OF FUTURES

Mr. Rubin, you expressed, I think quite appropriately, a lot of concern about the clearance system and noted that the clearance of futures is more of a problem than the clearance of equities.

Why is that?

Mr. **RUBIN**. People argue both sides of this. I guess to me the clearance of futures seems more troubling because if you have an enormous 1 day move as we had on October 19, the initial margin that has been put up in the futures market is a much lower percentage of the asset value than you have in the stock market.

Senator **SANFORD**. But they clear on a cash basis daily at least.

Mr. **RUBIN**. The advantage of futures over stocks is they clear daily and you have mark to the market on a daily basis as opposed to a 5 day waiting period. That is correct. But in the individual day if we have a market collapse, you can have, unfortunately, less margin in the system than you need.

Senator **SANFORD**. But that would have to do maybe with the amount of the margin instead of the clearing system.

Mr. **RUBIN**. It's not the system. I think that's correct, Senator. It's the amount of the margin. On the other hand, the more you increase the margin, unfortunately, the more you deter participation in the futures market and therefore the less liquidity and less efficiency. So it's a tradeoff and you have to decide where you strike your balance.

Senator **SANFORD**. In several of the reports a great deal was made of the fact that the so-called portfolio insurance development had contributed to the difficulty of clearance or the difficulty of trades. Do you think portfolio insurance is dead of its own weight?

Mr. **RUBIN**. My impression, Senator, is that portfolio insurance is basically a hedging technique and my impression is that it has served its users well in most circumstances and I suspect it will continue to be used actively.

Senator **SANFORD**. But not relied on to a considerable extent?

Mr. **RUBIN**. I think probably people have greater skepticism than they have had in the past.

Senator **SANFORD**. We have heard testimony both today and in previous hearings that portfolio insurance created false comfort.

Mr. **RUBIN**. I think people will view it as less foolproof than they did prior to October 19.

Senator **SANFORD**. In your comments about the circuit breakers, it's hardly a circuit breaker, but the mild action taken by the New York Stock Exchange of stopping the DOT transactions if the market shifts 50 points, does that make any difference? Does that have any effect?

Mr. **RUBIN**. Well, there was an article I think it was in last Friday's New York Times which said the answer is no. I think I'm inclined to disagree with that article. I think on balance it probably has been useful, but I think what it does by addressing the problem you just raised with respect to portfolio insurance it to some extent delinks the stock index future and the stocks when the market moves more than 50 points which in turn makes the stock index future a less efficient market and by making it less efficient may deter to some extent portfolio insurance and wave selling at a time when you least want to have such selling.

Senator **Sanford**. So it might not affect insurance so much as the wave of selling?

Mr. **Rubin**. Yes.

Senator **Sanford**. It seems to me that just as much selling went on. They just had to do it with a slower process than the DOT.

Mr. **Rubin**. Well, that's correct. It got done manually. Because it was done manually rather than via DOT, I think that the stock index future probably sold at a somewhat greater discount to the cash market and that may to some extent have deterred the wave of sellers. If it didn't, then it wouldn't have served any purpose I don't believe.

Senator **Sanford**. Well, let me ask both of you this then, if I may. You both fairly well reject the Proxmire agenda, the terms of the Proxmire bill.

SUPPORT FOR S. 2256

Mr. **Russo**. No, I don't. I think it's a good idea.

Senator **Sanford**. You think the bill is good?

Mr. **Russo**. Yes.

Senator **Sanford**. And for now?

Mr. **Russo**. Yes. I would have added things to it. I think it is a good idea. I think it's necessary to have a formal mechanism of coordination. It satisfies a lot of people in the sense that it leaves the CFTC as is, it leaves the SEC as is. It gets the Fed involved in the process and the Fed is involved in the process and was probably the major player on the 19th and the 20th of October 1987. It takes areas which were singled out by the presidential commission as important and it says maybe we ought to do something about them.

It doesn't go overboard. It mandates cooperation in certain areas which, on their face, deserve cooperation.

Senator **Sanford**. Thank you for clarifying that for me. I did hear you say that you favored the majority vote that's described in the bill.

Mr. **Russo**. Yes.

Senator **Sanford**. That was really preliminary to my asking this question of both of you. What should the Congress do? Mr. Russo, you have answered this but you also said there are some other things you would have put in the Proxmire bill. What other things would you have us do?

Mr. **Russo**. Well, the bill is very general. It's a little bit like the Brady report itself. It gives general direction and I don't know if you would put this in the bill or you would put it in the committee report, but I would deal with some specific issues. In clearing, for example, I think there has to be a little bit more direction than is in the bill itself. In the committee report you ought to spell out some of the things that should to be done because clearing is the most important issue.

Senator SANFORD. Do you favor a unified clearing system?

Mr. RUSSO. Yes. There are a lot of issues that have to be dealt with and I won't go into them now.

Senator SANFORD. Let me change that word unified to single. Do you favor a single clearing system?

Mr. RUSSO. That's a difficult question because you want a unified system. If you wanted a single system you would wind up merging many of the clearinghouses. I just don't think that's going to happen, though I think it may make some sense. But having them interconnected I think does make sense. Having a uniform system of information sharing and assessments I think makes sense. I think it also makes sense to tie it into the securities options area along with anything else that gets marked to market on a daily basis. I think it ought to be spelled out that unified clearing also means cross-margining because it seems that where you have offsetting instruments in other areas such as if you have a security instrument and a commodity instrument that on balance you are net zero that you ought to be able to offset one another and not be a drain on liquidity. I would spell some of these things out.

I would also spell out that cooperation generally is necessary where areas of similarities outweigh the differences. I pointed out earlier in my testimony that certain areas such as hybrid securities should be the subject of cooperation among Federal agencies. I think there's a need for far greater cooperation than just those specific areas spelled out in the bill. Though maybe they are covered in the bill.

Senator SANFORD. Thank you very much. I think it's important that we put into the record some thoughts and ideas about the clearing system and the clearing houses. I noticed, Mr. Rubin, that you suggested that there be coordination to a degree that there could be a redirection of funds between clearinghouses, and may I ask you to elaborate on that, plus anything else you think Congress should do now?

Mr. RUBIN. Senator, I guess my view would be that Congress should wait and see what comes out of the efforts that are going on right now. I guess the thing that strikes me—I may have made this observation 5 years ago or 10 years ago with respect to all of these kinds of issues—these are tremendously complicated issues and almost anything you do is going to have not only the effect you seek but an awful lot of unintended effects. You do have both self-regulatory agencies and the SEC and CFTC that have tremendous expertise and understanding and feel for these issues. I think I would be very much inclined to see what they produce and then evaluate that rather than create a new overarching body which will then have to develop its own feel and one thing and another.

As far as clearing is concerned, the only point I was trying to make in there is that if you have a big balance of excess cash in one place and need cash in another, rather than having to funnel it through a bank you should be able to move it directly from one to the other.

I would hope—and I am not personally involved in this so I don't know, but I would hope that out of all of the work that's going on there will be a whole roster of measures to strengthen the clearing system with respect to its financial integrity to avoid the kind of domino effect that Senator Riegle referred to before.

Senator **SANFORD**. Thank you very much for being here.

Senator Graham.

Senator **GRAHAM**. Thank you, Mr. Chairman.

One of the issues which has surfaced in our previous hearings has been the importance of international coordination and the disadvantage which the United States has in promoting international cooperation in securities markets because of the diffused nature of our regulatory system in contrast, for instance to the level of international coordination among central bankers where the United States has a clear voice.

(A) How much value, Mr. Russo, would you put on the international dimensions of the subjects that we've been discussing; and (B) how effective do you think the troika approach which is being suggested would be as a representative of the United States in that international forum?

INTERNATIONAL COORDINATION AND COOPERATION

Mr. **RUSSO**. Well, I think we have to play a far greater role simply because so much of the capital is not in this country. Once you have accumulations of capital abroad you're simply, unless you have a very strong market, going to lose some of your market. I think that since all trading is really one market, since the futures are so related to the securities and everything is connected, it seems to me that if we're going to deal with our counterparts abroad that it should be through a mechanism that is not just through on accord with the CFTC and the United Kingdom or the SEC and the United Kingdom. Issues such as information sharing and clearing are common and a coordinated mechanism of negotiation with foreign counterparts is desirerable So I think it's a very helpful tool to speak with one voice and this bill is helpful in that regard.

Senator **GRAHAM**. Mr. Rubin, do you have any comments on that subject?

Mr. **RUBIN**. Well, the only comment I'd have is that where restrictions in certain respects prevent things from being done on the New York Stock Exchange today, U.S. investors will do those things in various ways in London. I think that if market regulations are more strict here than they are abroad, I suspect in time—but it will take time I think—you will develop effective markets abroad in U.S. stocks and futures on U.S. stocks. Therefore, it seems to me that international coordination is exceedingly important.

As far as how that gets accomplished, it's not something I've thought about particularly, but I would think that if you have the CFTC and the SEC they should be able to work out some way of developing—if they have a common stance, it shouldn't be too difficult for them to develop some way of communicating that effectively with foreign regulators.

Senator GRAHAM. Mr. Rubin, you commented relatively to the shortened timeframe within which investment decisions seem to be made. Would you elaborate as to some of the conditions that you think have contributed to that and what the consequences of that shortened timeframe are?

Mr. RUBIN. Well, I think what has basically happened is that most trading in the New York Stock Exchange is by institutions. Institutions have become subject to tremendous performance pressures from their principals—pension funds owned by corporations and things of that sort—money managers are subject to these kinds of performance pressures. The result is that instead of investing with a long-term perspective and waiting for 1 year or 2 or 5 or whatever that it would take to see how things work out, most people who run money today are accountable on a quarterly basis and if you're accountable on a quarterly basis and every quarter you run a risk the money is going to be transferred from you to somebody else, you tend to want to perform on a quarterly basis.

I think it's unfortunate and I think it probably has considerable implications with respect to the economy and the ability to put together a so-called patient capital for long-term investing. I also don't think there's a lot you can do about it, other than that I think we're probably better off when we had a preferential long-term capital gains rate than we are now without one.

Senator GRAHAM. Since many of these institutions are non-taxable institutions, such as State, local and municipal governments, the tax law would have limited impact on them. What would be some other ways that you think the institutional investor might be influenced to reach the economic judgment that it was in their best interest to take a longer view?

Mr. RUBIN. I've thought a fair bit about this, Senator, and I don't have an answer. My personal view, for whatever it's worth, is that if you have a long-term perspective you will probably do better than if you have a series of short-term perspectives. But, unfortunately, people who run money don't have the opportunity to play out that string and there may be things but I've thought a fair bit about it and there's nothing I have to suggest.

Senator SANFORD. Do away with quarterly reports.

Mr. RUBIN. Well, you could do that, Senator.

Senator GRAHAM. Well, that's sort of a Luddite thing, you deny information in order to cause people to act differently in ignorance. That's not a long-term strategy.

Mr. RUBIN. It has disadvantages, yes.

Senator SANFORD. Let me ask one last question of Mr. Rubin. How do we get centralized coordination in some of these crucial matters when the SEC and the CFTC do not agree?

Mr. RUBIN. Well, I think, Senator, one of two things is going to happen. You've got this Presidential task force and they have said they will come back before the end of May and you are either going to see that they have in fact been able to agree and work out coordinated and sensible proposals or you may decide you want to act in response to that. I've been involved, and I'm sure you've been involved in many, many more situations, where different parties are under great pressure and they wind up reaching agree-generally has supported the concept of cross-margining. This issue is, consequently, precisely the type of intermarket issue that would merit prompt attention from the ICC. Indeed, the bill should be modified to include a specific reference to cross-margining. In addition, the Banking Committee may wish the ICC to request a detailed status report on this issue from the CFTC, the SEC, and from the prime proponent of cross-margining, The Options Clearing Corporation.

Third Party Custody Accounts. Another significant source of liquidity pressure identified by the Brady Commission Report are so-called "third party custody accounts," which are used primarily by mutual funds and certain other institutional participants in the futures markets to hold their initial margin deposits in separate safekeeping accounts with custodian banks. These accounts drain liquidity from the financial system, by requiring carrying brokers to use their own financial resources to satisfy the initial margin requirements applicable to customer positions at the relevant futures clearinghouses. The SEC staff has been considering for some time a rule that would permit mutual funds to deposit initial margin for futures and options on futures contracts directly with their brokers. Because these accounts can play a role in undermining the integrity of the financial markets which, of course, is detrimental to the interests of the mutual funds themselves, I believe that the issues presented by the use of these accounts should be included

in this bill and would merit prompt attention from the ICC in the event that they are not resolved by the SEC.

Circuit Breakers. Senator Proxmire's bill recognizes that a coordinated regulatory approach is also necessary with respect to the development and use of so-called "circuit breakers." In my view, appropriate circuit breakers must be agreed upon before a market problem arises so that they do not cause panic when it appears that they may go into operation, thereby exacerbating the very conditions they are intended to remedy. In addition, because the financial markets really are one market, as the Brady Commission Report recognizes, circuit breaker mechanisms should be applied on a coordinated, intermarket basis. Positions can be assumed and unwound through either the SEC or CFTC-regulated segments of these markets so circuit breakers must be employed in a manner that takes into account the inevitable spillover effects on related market segments. By contrast, unilateral action by a single regulator or self-regulatory organization in times of market volatility, though well-intentioned, may cause further market dislocations and inadvertently lead to greater destabilization. In this regard, restrictions imposed in one market segment or index arbitrage transactions-- which are designed to "disconnect" the stock and futures markets in the event of sharp stock price movements-- may hamper efforts to deal with future market breaks in a coordinated fashion.

Hybrid Financial Instruments. I note in passing another example of unilateral regulatory action that has a broad intermarket impact and should be a topic added to Senator Proxmire's bill. Last December, the CFTC published for comment an advance notice of proposed rulemaking which suggests that many types of hybrid financial instruments that are offered or traded off of commodities exchanges are futures contracts or commodity options subject to CFTC regulatory and enforcement jurisdiction.

This release has profound implications for the legality of a host of financial products, ranging from indexed bank certificates of deposit to hybrid debt securities and swaps, as well as for the smooth functioning and global competitiveness of our capital markets generally. The release, for example, does not sufficiently consider the benefits of flexibility and innovation which over-the-counter financial markets provide. Despite the magnitude of these issues, which transcend existing lines of regulatory jurisdiction, the release apparently did not benefit from prior detailed review and coordination with the views of other interested regulatory authorities, such as the Treasury Department, the Fed, the SEC, the Comptroller of the Currency, and the FDIC. As a result, a great deal of uncertainty has been generated regarding the legality of vast numbers of transactions that previously have been viewed as outside CFTC jurisdiction, with potentially deleterious effects on our financial markets.

Capitalization: Bank Participation. I believe that the adequacy of current specialist and market-maker capitalization requirements should be explored, with the notion of raising them. Although the steps recently taken by the NYSE in this direction are laudatory and important, Congress should assure itself that sufficient progress has been made in this area. Similarly, steps taken by major investment banking firms to purchase specialist units or infuse them with additional capital should be encouraged, despite the potential for conflicts of interest.

In addition, in light of the clear need for a pool of well-capitalized specialists and market-makers, Congress should consider amending the banking laws to make clear that bank holding company subsidiaries can function as specialists or market-makers in financial instruments, provided, of course, that appropriate firewalls are in place to safeguard against conflicts of interest. Indeed, one of the lessons that we learned from the week of October 19th was that bank credit lines were crucial to maintaining the liquidity needed by specialists and market-makers. Because banks play such a crucial role on the lending side and also play a key market-making role in numerous over-the-counter financial markets, it would be logical and appropriate to permit them to play a more direct role in the exchange markets. Indeed, functioning as a market-maker on the floor of an exchange would entail substantially less risk than functioning in this capacity in the over-the-counter markets because added safeguards would exist. The landmark banking legislation recently passed by the Senate recognizes that banks and their holding companies have a necessary and appropriate role to play in the securities markets and sanctioning bank holding company participation of this nature in the exchange markets is a logical companion step.

__Manner of Trading__. Because the financial markets have become one, the ability to effect intermarket hedging and spread transactions would be facilitated if the manner in which trades are effected in those markets were similar. In the securities industry, traders are permitted to assemble blocks of stock in the upstairs market. Such transactions permit securities firms to identify and match efficiently interested buyers and sellers in large-size transactions, without causing price distortions that could occur from dumping large blocks of stock on the floor of an exchange. On futures exchanges, in contrast, such transactions unfortunately are considered by some to violate the commodities law requirement that trades be executed by "open and competitive outcry." In my view, the flexibility to assemble large trades away from the trading floors of commodities exchanges would be helpful in avoiding additional sources of price pressure during periods of market volatility. I therefore believe the bill should include alternative trading formats as one of the areas with respect to which the ICC should implement regulatory improvements.

__Regulatory Structure__. My final comment deals with the appropriate regulatory structure for our financial markets. I agree with the approach embodied in Senator Proxmire's bill that

the optimal regulatory structure would be a joint panel composed of the Chairmen of the Fed, SEC and CFTC. Such a panel would allow a comprehensive and coordinated regulatory approach to be employed with respect to the matters identified in the bill. I therefore urge adoption of Senator Proxmire's bill, with the few modifications that I have suggested in my testimony.

I think this bill gives the CFTC and SEC a needed signal that, if they cannot work together to address these critical issues in an effective and timely fashion, Congress will have no choice but to act. The financial markets cut across regulatory turf as well as national boundaries. If regulatory agencies or self-regulatory organizations take a myopic or parochial view of these issues, they are not only closing their eyes to the reality of the financial marketplace, but jeopardizing the primacy of this nation's capital markets.

Thank you very much for the opportunity to testify before this Committee.

ment because of the pressure of the situation and one would hope that that's what will happen here. I think you keep that pressure on and if they do come up with an agreement, get a status report. Lower the cost.

Senator **Sanford**. I think they can agree on an approach but down the road you might have a disagreement on something such as the level of margins. How then would we resolve that disagreement? Presumably, there wouldn't be any pressure, from Congress or others at that time to coordinate action.

Mr. **Rubin**. Well, it would be one of two situations. One is that you have an emergency, an another October 19, and I guess my view would be that the pressure of an October 19—I think the odds ought to be very high that the pressure of an October 1h will cause people to come together and make a decision.

Senator **Sanford**. Yes, but we're trying to get them together to make a decision before we have another October 19th.

Mr. **Rubin**. I agree. On an ongoing basis, Senator, I guess something I think you might want to consider is having some kind of a status report in a year or something like that so they know they have to face you again.

Senator **Sanford**. You might say then this is still an open matter in your mind?

Mr. **Rubin**. I think it is certainly an open matter.

Senator **Sanford**. Let me thank all of our witnesses and thank the staff for all of their work. Thank you for being here and giving us this very valuable assistance.

[Whereupon, at 12:40 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

Hearing on the Regulators' Recommendations for Legislation
Dealing with the Stock Market Crash of October 19, 1987

WRITTEN STATEMENT OF

SHERWOOD H. SMITH, JR.

PRESIDENT AND CHIEF EXECUTIVE OFFICER

CAROLINA POWER & LIGHT COMPANY

ON BEHALF OF

THE EDISON ELECTRIC INSTITUTE

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

U.S. SENATE

MARCH 31, 1988

Mr. Chairman and Members of the Committee:

I am Sherwood H. Smith, Jr., President and Chief Executive Officer of Carolina Power & Light Company. I have served as Chairman of the Edison Electric Institute. I am also a member of the Listed Company Advisory Committee of the New York Stock Exchange, but my comments here are not submitted on behalf of this Committee. I am very pleased to provide this statement on behalf of the Edison Electric Institute (EEI) to the Committee on the overall need for stable as well as flexible and efficient capital markets in order to meet the requirements faced by the investor-owned electric utility industry to provide adequate, reliable and economical electricity. EEI is the association of electric companies whose members serve 97 percent of all customers served by the investor-owned segment of the industry. They generate approximately 76 percent of all the electricity in the country and serve 73 percent of all ultimate customers in the nation.

The Electric Utility Market Place

The electric utility industry plays a significant role in the U.S. economy. Use of electricity as a percentage of U.S. energy requirements has grown from 32.2 percent in 1980 to slightly over 37 percent in 1987. Increasingly, electricity is the energy of choice in the U.S. and plays a significant role in the economic and physical well-being of Americans. Unlike most industries, the utility industry has a mandate to provide its customers with an adequate and reliable supply of electricity at an economical cost.

Our industry is heavily dependent on a stable and efficient capital market. The electric utility industry invests billions of dollars annually in construction programs, making it the most capital-intensive business in the U.S. investing over $3 in land, building and equipment for every dollar of operating revenue. For every $3.03 of investment, the electricity industry generates one dollar of sales, while the average industrial firm invests $0.60 for every dollar of sales.

In order to maintain and construct the necessary plant and equipment to serve customers, a utility uses two sources of financing: 1) funds generated internally through operations; and 2) funds generated externally through the financial markets from the sale of stocks, bonds and bank loans. During a period of heavy construction, such as was experienced during 1984, electric utilities spent over $36.6 billion dollars on construction of which approximately 50 percent was generated internally. Thus, $18.4 billion had to be raised in the capital market. During that year, the electric, gas and water industries issued 8.3 percent of all common stock publicly offered and 9.1 percent of all corporate debt. During 1986 these industries offered 10.5% of all common stock and 12.6% of all corporate debt. These are clearly impressive numbers. Even in 1987, a period of relatively low construction for electric utilities, the electric, gas and water industries issued 7.4 percent of all common stock publicly offered and 8.4 percent of all corporate debt. It was through these means that the electric utility industry was able to finance its construction programs. During 1987 companies' construction programs totalled $29.1 billion with about 70 percent of the program financing generated internally. This required that only $8.8 billion for construction be raised in the capital market.

Because of electricity's importance to the economic infrastructure of the U.S., capital projects cannot be delayed or postponed. In fact, the long construction periods for generation plants (for example, 8-10 years for coal facilities and 14-16 years for nuclear plants) make construction delays difficult if not impossible. Our industry, unlike others, must maintain an ability to continuously raise large amounts of capital with sufficient ease and efficiency, so as not to jeopardize construction programs while at the same time not raising customer rates. Both a volatile market and high capital costs will translate directly into added costs that utilities are forced to pass to customers in the form of higher rates. If the price of electricity increases throughout the Nation, overall American productivity and competitiveness are negatively affected.

Future Capital Needs

Forecasts of electricity demand indicate that over the next five years, both peak electric load and kilowatt-hour requirements are projected to grow at an average of about 2 percent annually. Over the same period, capacity additions are expected to increase at an average annual rate of slightly over one percent. While we are currently winding down a construction cycle, almost all forecasts call for new generation requirements in the 1990's. Despite the current forces to move the electricity market into a competitive bidding arena with utilities taking power from non-utility producers, our industry will still be required to construct generating plants to meet increased demand. This will increase the need to raise the necessary capital to finance construction programs. In addition, we also have a continuing need through our forecast period of 1990 to expend about $10 billion per year for transmission and distribution facilities.

The North American Electric Reliability Council (NERC), in its September 1987 report, forecast that an additional 79,300 MW of capacity will be needed by 1996 to add to our current capacity of 716,000 MW in place at the end of 1986. Of these capacity additions, approximately 45% or 35,700 MW are not yet under construction. Assuming a mix of fuels to compose these capacity additions, and an average capacity cost of $2,200 per KW as estimated by the Utility Data Institute, these additions could represent expenditures approaching $175 billion. If half of these

expenditures are met from internal sources, it leaves $87.5 billion to be financed from external sources by the year 1996 to meet just these plant additions. Furthermore, by 1996 the NERC forecasts that this industry will have to add approximately 20,000 miles to its existing 183,000 miles of high voltage transmission lines, further adding to the future capital needs of the industry.

S. 2256 - Intermarket Coordination Act

When introducing S. 2256, the Chairman observed that havoc in our financial markets could "export" our status as the preeminent financial center in the world to London, Tokyo or other market centers which are able to meet the challenge of modernization and stability. The electric utility industry would, of course, be adversely affected to a serious extent should anything like that occur.

The bill, as we understand it, is based largely upon findings and recommendations of the Brady Commission's Report on Market Mechanisms. The bill would create an Intermarket Coordinating Committee to act upon the seven major recommendations of the Brady Report. As head of the proposed committee, the Chairman of the Federal Reserve Board would act as tie breaker on issues of irreconcilable difference between the Securities and Exchange Commission and the Commodities Futures Trading Commission. I have not had an opportunity to carefully consider this proposed legislation, nor has our industry. But, I do have some initial comments to make.

The bill identifies the markets' need to develop information systems for monitoring intermarket trading strategies and for detecting/prohibiting various trading abuses. The implementation of such systems could have a favorable impact on the U.S. markets' competitive position because the integrity of these markets would be enhanced. Thus, if indeed such benefits resulted from the legislation, this would be of value to our industry from the standpoint of its ability to raise capital.

One area which may require more analysis deals with margin requirements in the futures market vis a vis those in the stock market. There seems to be no question but that something needs to be done to reduce the elements of pure speculation and "gambling" with the futures market and perhaps the stock market. We are aware, however, that some argue that overly prescriptive rules in this area could add substantially to the cost of using futures to hedge against stock market risk, and that such a development would detract from U.S. markets' ability to compete with the other major financial markets of the world.

In general, the Edison Electric Institute encourages a cautious approach to new federal regulation of the U.S. financial markets. These individual but interrelated markets should be given the opportunity to identify and solve their problems. They should know they must work to reduce their participants exposure to another market break like the one in October 1987. This realization, along with global competitive pressures, should form the stimulus for prompt, effective and cooperative action. If

however, effective action from the markets themselves is not forthcoming then perhaps federal legislation will be required.

Capital Market Regulation

While uncertainty and volatility increase the cost of capital to all industries, overly restricted markets could reduce flexibility and access. Such an environment could have the undesired effects of also increasing the cost of capital. Thus, it is essential that an adequate balance be sought between a regulated market place and one that is flexible and allows for sufficient accessibility. Furthermore, in seeking a flexible balance, it is important that international financing and markets be considered when examining controls and access. As in the past, utility companies should be allowed to seek financing in the international markets wherever advantageous to do so. Conversely, our companies' financing abilities, even domestically, are affected by international markets.

We urge the Committee to examine the recent events that significantly impacted financial markets. We ask that, where necessary, protections against market failures or severe market instability be provided. On the other hand, there should be reliance to the extent possible, on the normal, efficient operation of financial markets.

Regulation that protects the public is desired, which will assist in making the marketplace readily accessible and produce efficiently priced capital. The electric utility industry's future financial well-being and competitive strength will rely, in part, on the balance sought by this Committee and by voluntary changes and reforms by the market themselves.

Mr. Chairman, we appreciate the opportunity to provide these comments and trust that we may participate in any future hearings or other proceedings.

THE INTERMARKET COORDINATION ACT OF 1988

WEDNESDAY, MAY 11, 1988

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Sanford, Graham, Wirth, Garn, D'Amato, Hecht, Gramm, and Bond.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The Chairman. The committee will come to order.

Today we hold our ninth day of hearings on the events following the market crash in October. It will be our last hearing before yet another Presidential working group submits its recommendations to the President on or before May 18.

I could not agree with former Senator Nick Brady more, we need to stop talking about the issue and act. We can talk about clearings, margins, circuit breakers, and better information, but the central issue is what kind of responsible decision making structure and apparatus are we going to put into place in order to make sure that what the people recognize increasingly as one market is actually regulated as one market.

I've introduced a bipartisan bill, sponsored by 5 Democrats and 5 Republicans, entitled "The Intermaket Coordination Act of 1988." It provides for such a coordinated, centralized decision making structure without creating one super regulatory agency. It also requires that careful review be given to each of the recommendations made by the President's task force.

From everything I can gather, the most recent Presidential study group under the direction of Treasury Secretary Baker believes that somehow the various private self-regulatory agencies on their own can coordinate policy regarding the markets, in spite of their clearly legitimate but competing self-interest. Or if that fails, then the SEC with its constituency and jurisdiction, the CFTC with its separate agenda, and the Fed which has up until now expressed no interest in these subjects, can somehow on an ad hoc basis set coordinated policy over our stock, options, and futures markets.

Anyone who believes that coordinated policy can be established under the present system or that major improvements in our market mechanism systems are not needed is naive. I would hope that the President's working group would carefully consider the complete hearing record we have established in the Senate Banking Committee on these subjects. On May 24, the working group will testify before the committee and will give us their findings. I will be looking for specific suggestions as to how they would improve our bill, S. 2256. If they have none, we will make every effort to proceed legislatively without them.

In the meanwhile, we have today a superlative group of witnesses led by former Secretary of Treasury and Merrill Lynch Chairman Don Regan, and others.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator Garn. Thank you, Mr. Chairman.

Today's hearing provides still more testimony about the stock market crash. The Brady Commission report and other proposals to change the regulation of the stock and financial futures markets. That's important because we certainly do need a clear understanding of the consequences of any reform measure before we plunge ahead with changes.

In that regard, we must be careful to create a balanced hearing record and I suspect that there may be some interested parties who may want to respond to the points of view expressed by today's witnesses.

Congress has shown unusuaal and, in my opinion, well advised restraint in avoiding hasty reactions to the complexity of financial market reform and I think that should continue.

The administration plans to announce the results of its interagency coordinating group sometime next week and this committee will hold a hearing on the subject the following week. It may be that the most important of the proposed reforms can be achieved under existing law through the regulations and the self-regulatory organizations.

Whatever changes are made, I want to repeat what I have said in several previous hearings. In the name of reform, we do not want to impose a regulatory scheme so burdensome that it moves financial markets from our country to others around the world. Not only would this take away jobs, but it could allow market participants to avoid the intended reforms while at the same time shutting out the ability of the U.S. regulators to address the problems. It is not enough to say that other countries should adopt similar schemes, since we have no control over their affairs and since such coordinated regulation usually takes a great deal of time.

Yes, we need to restore the confidence of the investors, particularly individual investors, in the financial markets. That does not mean that Congress should pass laws with side effects which could be worse than the disease. I do not support needless delay, but I also do not support ill considered solutions to a very complicated problem.

Thank you, Mr. Chairman.

The Chairman. Thank you, Senator Garn.

Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Mr. Chairman, as the chairman of the Securities Subcommittee, I want to just acknowledge the particular strength and importance of this panel of witnesses. We've heard from a lot of people, but we have three particularly outstanding witnesses at the table today and I want to particularly take note of Secretary Don Regan, who has really served on both sides in a very important long-running public service stint at the top of our Government in these areas of the way our economy works and, as well, was the CEO of Merrill Lynch and had a very distinguished record on the private sector side.

In reviewing the testimony today, I find it to be explosive and I will have a number of questions that I want to raise, but I'm very pleased that our witnesses are here.

The CHAIRMAN. Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, I am a Leo. Secretary Regan, you are a Saggitarius I understand.

Mr. REGAN. I understand that, Senator.

Senator D'AMATO. So I've done a little checking, some research and let me share with you the horoscope for today. "Not until after the sun has made a decisive aspect to Mars on the 17th can you hope to get your point across on the work front or force colleagues to be more understanding."

So I thought with that admonition you would understand that some of us——

Mr. REGAN. That's yours?

Senator D'AMATO No, that's yours.

Mine isn't much better. It says, "You are not noted for letting sleeping dogs lie." It goes on, "In fact, if you're a typical Leo, then you are very much inclined to sound off until you become physically exhausted." [Laughter.]

Mr. Chairman, let me commend you for these hearings. I'm particularly appreciative of the fact that former Secretary Regan—that you have asked him to participate because as I indicated it wasn't too long ago I turned on the TV—this was before your book came out, Don—and there I saw you. I thought it was an Al D'Amato. You were animated, almost aggitated as it related to—I think it was Good Morning, America with Brian Gumble and Jane Pawley.

Mr. REGAN. No, Today.

Senator D'AMATO. It was the Today Show? Well, you do the lecture circuits so you know. So it was the Today Show and you made the point—and I suggest it to the chairman after having seen you—that it would be good to hear you testify as it related to what you characterized as the wildly speculative market that had been created as a result of some of the uses of the indexes that have no relationship to a commodity and that where a one point swing as it related to the foreign exchange would create these abberations and that you thought that certainly something should be done, and I'd be most interested in hearing you testify with some detail in relationship to that because I myself have a feeling that there are these unknown forces out there, unknown to many of us and to those in the general public, that have exacerbated the market swings. So I look forward to your testimony today.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Wirth.

OPENING REMARKS OF SENATOR WIRTH

Senator WIRTH. Thank you, Mr. Chairman.

Just briefly to commend you again on doing this and to echo your own impatience which I share with the regulators' inability to get themselves together and to come up with a more coherent package. You've been talking about this for a long time. Jerry Corrigan of the New York Federal Reserve was raising this same issue. Senator Graham and I raised it in legislation that we introduced. The committee has echoed this in the banking legislation which we passed about 6 weeks ago that requires this kind of coordination.

So I hope that we can continue to put pressure on the regulators and maybe we'll have to come up with a legislative package. Gentlemen, we really appreciate you being here this morning and helping us keep that pressure on and get a broader coordination. I think we absolutely need it. Most people agree with that and I thank you all very much for being here.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hecht.

OPENING REMARKS OF SENATOR HECHT

Senator HECHT. Thank you very much, Mr. Chairman.

As I've spoken to this committee before on these matters, I still advise caution. I don't think we should legislate in haste without all the facts. I think the SEC, I think the marketplace are working, the brokerage firms are taking steps in their own firms to build confidence. It's certainly in their best interest to build confidence because without confidence they won't have any business.

So before we legislate and act in haste, as many people are trying to advise us to do, let's make sure we have all the facts because it's far, far too important a decision when we start legislating as far as the stock exchange. This is what's built America, all the countries around the world are involved in it and it's just too important to proceed in haste.

Senator RIEGLE. Senator Bond.

OPENING REMARKS OF SENATOR BOND

Senator BOND. Thank you very much, Mr. Chairman. I'm very pleased that we are continuing to push ahead with hearings on the events of October 19. I think there's much we still have to learn on the subject and I think that congressional interest and attention could help move the process along, at least that's my hope.

It seems to me that we have a basic decision to make whether to try to adapt to the realities of the stock market dominated by institutional investors, or whether to try to roll back the charges. We can either increase market capacity to deal with the high volume and the volatility or we can outlaw the instruments that make such trading strategies possible in the first place.

Looking over the testimony that you gentlemen have submitted already, I see that you generally make the case that as a society we cannot afford to have wild volatile markets disconnected from the rest of the economy because it would harm capital formation. As a matter of fact, it has driven many of the individual investors out of the market, which I think is a real tragedy for our country.

I share your concern about small investors having pulled out of the market. I agree with the critique but I'm somewhat dubious of the extreme steps suggested as remedies. There are many regulatory reforms yet to be put in place before we need to consider banning stock index futures or index arbitrage. I think we need more unified regulatory structure, coordinated clearing and settlement systems, and better information systems, and audit trails. I hope that the publicity over the program trading changes made yesterday doesn't distract us from these goals because that in and of itself may not solve all the problems.

I do look forward to the testimony of the witnesses and the discussions that we will have thereafter. Thank you.

Senator RIEGLE. Thank you, Senator Bond.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, let me welcome those that are here to testify. Obviously we're dealing with an important issue. We want our capital markets to be stable. We also want them to work, and we're not indifferent about where they're located.

We are now the center of the world in terms of capital transactions, and I don't want to see that change. While our whole focus on the day that the 500 point collapse in equity values occurred was on the stock market, I think it is very important to note that on that same day there was sufficient movement in bond prices that the bond market hit its limit, shut down, and there was an 800 percent increase in similar transactions in London. I think this is a warning to us as we consider taking actions to have circuit breakers to give us an opportunity to adjust to increased volume. The idea that we can simply pass a law to shut the market down if prices move outside a given range in a given period of time has me worried if that shutdown is for anything other than allowing the payment system to adjust to allow information to be dispersed—and I think those are legitimate things that we ought to look at. If the market shut down is for any other objective, if the idea is simply to say we're not going to let equity values move by a certain amount on a given day, then I think that's destined to be destabilizing. There's nothing worse than having something you want to sell that somebody else wants to buy at a price you're willing to accept and not being able to do it because the market is shut down. In the world market we live in, that kind of situation is not going to exist for long. I think we have to look as we make these important decisions at how we can allow the payment mechanism to work, and at the same time do it in such a way as to maintain our competitive edge and maintain the focus of these worldwide equity markets in our country.

I'd like to say also, Mr. Chairman, that I am not overwhelmed by these arguments against computer trading. I understand that the volumes they produce put the system under great stress. I, for one, think we need to learn to live with that. I think this whole logic that somehow by using computers, people can use information quicker, they can enact transactions quicker, and therefore that makes the system unstable—if that logic were really true, maybe we ought to ban the calculator and the ballpoint pen and the telephone.

I think the reality is that there are technological breakthroughs which have occurred. Those technological breakthroughs allow the processing of tremendous amounts of information. They allow the small dealer to be more competitive with the big one. I think those are technological changes that are here to stay. I think that while we need to look at these changes and we need to look at what impact they have, in the final analysis we're going to have to learn to live with them. The regulators are going to have to learn to generate a system that will accommodate the volume of trading that we're looking at.

So I, for one, am willing to look at tinkering with the market if our objective is to make it work better, if our objective is to use a circuit breaker to prevent the house from burning down. But if the circuit breaker is simply to prevent markets from working, when changes are driven by fundamental economic forces, I think the net result is going to be that markets are going to work poorer, that less capital is going to be accumulated, and that the economy is going to be the loser.

Senator RIEGLE. Thank you, Senator Gramm.

I have a statement from Senator Dixon to be inserted in the record.

MAY 11, 1988

Alan J. Dixon

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITEE HEARING
ON
FINANCIAL MARKET REFORM PROPOSALS

MR. CHAIRMAN, I AM PLEASED TO BE HERE THIS MORNING AS THE BANKING COMMITTEE CONTINUES ITS HEARINGS ON PROPOSALS TO RESPOND TO LAST OCTOBER'S STOCK MARKET CRASH. WE HAVE A DISTINGUISHED GROUP OF WITNESSES BEFORE US THIS MORNING, AND I LOOK FORWARD TO THEIR TESTIMONY.

AT THE OUTSET, I WOULD LIKE TO COMMENT ON TWO ISSUES. FIRST, AS MANY OF MY COLLEAGUES KNOW, CONGRESS HAS BEEN CRITICIZED BY THE MEMBERS OF THE BRADY COMMISSION AND OTHERS FOR NOT ENACTING LEGISLATION TO RESPOND TO LAST OCTOBER'S STOCK MARKET CRASH. I AGREE WITH THE BRADY COMMISSION MEMBERS THAT THE STOCK MARKET CRASH WAS A FRIGHTENING EVENT -- ONE THAT DESERVES OUR CAREFUL

ATTENTION. HOWEVER, I DO NOT SHARE THEIR SENSE OF ALARM OVER THE FACT THAT THERE HAS BEEN NO LEGISLATIVE RESPONSE.

I THINK THE ONLY WAY TO RESPOND TO THE PROBLEMS HIGHLIGHTED BY THE CRASH IS CAREFULLY AND DELIBERATELY. A "QUICK-FIX" SOLUTION DIRECTED SOLELY AT THE OPERATION OF OUR MARKETS DUPLICATES THE EFFORTS OF THE PRESIDENT'S WORKING GROUP -- WHOSE RECOMMENDATIONS WILL BE MADE NEXT WEEK -- AND, EVEN MORE IMPORTANTLY, IS VERY UNLIKELY TO PREVENT FUTURE EPISODES OF VOLATILITY.

THE WASHINGTON POST MADE THIS POINT VERY PERSUASIVELY IN AN EDITORIAL IN THEIR SATURDAY EDITION ENTITLED "REMEMBER THE CRASH?". THE POST POINTED OUR THAT WHILE " THE FINANCIAL MARKETS' DEFECTS, AS THE CRASH REVEALED THEM, ARE 'STILL IN PLACE AND NEED TO BE ADDRESSED'..... THE DELAY [IN RESPONDING] IS NOT AS OUTRAGEOUS AS IT LOOKS." THE POST GOES ON TO POINT OUT THAT "THE REMEDIES ARE NOT ENTIRELY OBVIOUS, AND THERE'S A STRONG CASE FOR MOVING CAUTIOUSLY." I SHARE THAT VIEW.

I ALSO WANT TO NOTE THE FACT THAT FIVE MAJOR WALL STREET FIRMS HAVE ANNOUNCED A MORATORIUM ON "PROGRAM TRADING" FOR THEIR OWN ACCOUNT. I LOOK FORWARD TO LEARNING MORE ABOUT THIS MORATORIUM. AT FIRST BLUSH, HOWEVER, IT SEEMS SOMETHING OF A MIXED BLESSING, AT BEST.

I HAVE BEEN DISTURBED ABOUT REPORTS IN THE PRESS THAT MAJOR FIRMS HAVE ATTEMPTED TO MANIPULATE THE MARKETS BY SUCH THINGS AS TRADING AHEAD OF THEIR OWN BLOCK TRADE DESKS. THE MORATORIUM SHOULD PROVIDE A TEST OF WHETHER THAT ACTIVITY WAS IN FACT OCCURRING, AND WHETHER IT DID CONTRIBUTE TO MAKING MARKETS MORE VOLATILE.

ON THE OTHER HAND, ONE OF THE PRINCIPAL CONCLUSIONS OF THE BRADY COMMISSION WAS THAT THE FUTURE, OPTION, AND STOCK MARKETS ARE IN FACT ALL ONE MARKET. SUSPENDING INDEX ARBITRAGE ACTIVITY, THEREFORE, MAY HAVE THE EFFECT OF INCREASING, RATHER THAN REDUCING, MARKET VOLATILITY.

Let me say to each of the witnesses before we start, you all convey a great sense of urgency in your testimony today and one of the things that I would hope that you would find a way to elaborate on is if the kinds of recommendations that each of you make are not taken, what are the real risks and consequences as you would see them to our economic future? I think we need to understand what you see as the real threat out there in the event corrective actions of the type that you support are not taken.

With that, let me start by recognizing our first witness, a man who served for many years as the Secretary of the Treasury and before that as the CEO of Merrill Lynch. We're delighted to have him with us today, former Secretary Don Regan.

STATEMENT OF DONALD T. REGAN, PRESIDENT, REGDON ASSOCIATES; FORMER SECRETARY OF THE TREASURY

Mr. **Regan**. Thank you, Mr. Chairman.

I appreciate your kind invitation and I can honestly say I am happy to be here with you this morning. Even though your hearing comes at an interesting time in terms of my own personal activities, I thought it was important to respond.

Due to events in the markets last October and continuing in the present, I feel the performance of our market mechanism is in doubt, if not in jeopardy. I will quickly go over the brief statement which I've submitted in advance in accordance with your rules.

Mr. Chairman, I'd like to add a P.S. to that. In view of the announcement in today's papers of yesterday's action by five leading Wall Street firms to voluntarily curb their own program trading. I applaud that act. I think it is a step in the right direction. It's not a giant step. It is a step. And, of course, it is following, it's not leading. They are reacting to what they have read in the press, to these hearings, and things of that nature. I would prefer that they get out and lead rather than just to act on the basis of being forced to do something. I think the time is short that they have to do this. If there's another market break, then the public is going to demand that the Congress act.

Thank you very much, Mr. Chairman.

[The complete prepared statement of Mr. Regan follows:]

TESTIMONY OF DONALD T. REGAN
BEFORE THE SENATE BANKING COMMITTEE
May 11, 1988

Mr. Chairman. We meet this morning almost seven months after perhaps the greatest stock market crash in history.

In the wake of last October, no one has doubted a message was, and is, being sent by the markets to all of us. I'll get to what I think the message is, but let me start by commenting on the reactions.

The reaction, simply, has been a classic one: a turf fight, both by the regulators and the industry.

First, of course, a commission was established, the Brady Task Force. It recommended that the Fed assume a super-regulator role to assure that the SEC, CFTC, and others, have a consistent, mutually supporting regulatory stance. In an unusual move for Washington, the Fed declined the honor, apparently believing that its monetary policy responsibilities were more than enough to keep it busy. I agree.

But the SEC and CFTC are now fighting for supremacy, with little likelihood for -- as the diplomats call it -- a peaceful solution.

At least partly in response to the lack of consensus on this, and other issues, the Administration set up the Gould Working Group to pursue solutions.

The reaction by the regulated, of course, has been to caution against "rash action." It is no exaggeration to say that all the study amounts to is rearranging the deck chairs on the Titanic.

We face an immediate problem, one with profound long-range implications. It's a problem which may do for the U.S. economy in the late '80s, and early '90s, what Smoot-Hawley did for -- or to -- the U.S. in the '30s.

I'm concerned about what might be called the "unreality" of our financial markets. Economic theory taught, and still teaches, that stock prices are part of an efficient market, and reflect underlying values.

Well, did the U.S. economy lose 20% of its value in one day almost seven months ago? Of course not! Was it going to lose another 20% of its value over the next six months or so, as it would if we believed the stock market has a predictability factor in its pricing? Not so -- the economy is much stronger today than six or seven months ago. So what was the market saying?

Last fall's market collapse and mid-April's plunge have to be taken as a warning. The warning is not that the real economy is about to collapse. The traditional economic indicators may be flashing yellow, but they are not red. In this, frankly, I disagree with many who cite the twin deficits as the most important cause. The real economy -- jobs, growth, inflation -- is in pretty good shape. The most publicized "scare" numbers, the trade and budget deficits, while troublesome, have stabilized, and, in relative terms, they are improving.

This is true today. It was true last October. So how does one explain how a $1.4 billion change in a notoriously unreliable monthly statistic -- foreign trade -- could trigger April's $100 billion drop in stock prices, or January's drop of 140 points in one day?

No one can be expected to plan, or predict, with any reasonable accuracy if values can change by 5% or more in a day, as they did a few weeks ago. I say the main cause of each of these declines was due to program trading -- particularly index arbitrage.

As sympathetic as I might be with the plight of market forecasters, what is most disturbing about the dominating impact of program trading is that it is fundamentally changing, and endangering, the basis on which our economy and stock market have functioned for generations: the individual -- whether as consumer, or investor.

The bulk of stock ownership is still with individuals -- over 60% of all equity -- but institutions for years have dominated trading. If the public feels that the markets are rigged, not only in favor of the big guy, but also in favor of some unidentified computer-based trading strategy, then confidence in our markets, indeed in our system, will plummet, with a further effect on values, and economic performance.

For the life of me, I cannot imagine why the leaders of our financial and business communities don't recognize this, and act to restore the individual's, and small institution's, confidence in the functioning of the markets. Without being too cynical, it might be that some major Wall Street firms and institutions have gotten hooked on the money they're making in quick killings, takeovers, program trading, or insider dealings -- and so they ignore the plight of the individual investor.

A stock market whose main participants are speculators and their programs cannot be a healthy market -- and an

Senator **Riegle**. Thank you, Secretary Regan.

Mr. Ball, let me welcome you. You're next on our list here. You're the chairman of the board of Prudential-Bache Securities and we would be pleased to hear from you at this time.

STATEMENT OF GEORGE L. BALL, CHAIRMAN OF THE BOARD, PRUDENTIAL-BACHE SECURITIES, INC., NEW YORK, NY

Mr. **Ball**. Thank you, Mr. Chairman. Thank you for the opportunity to appear here today.

[The complete prepared statement of Mr. Ball follows:]

Senator RIEGLE. Thank you, Mr. Ball.

Our next witness is Mr. Charles Schwab, the CEO of a very fine major investment company or securities company in San Francisco, and we would be pleased to hear from you now, Mr. Schwab.

STATEMENT OF CHARLES R. SCHWAB, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHARLES SCHWAB & CO.

Mr. SCHWAB. Thank you, Mr. Chairman. I want to mention one thing at the beginning in the spirit of full disclosure, that I am a Leo, in case it has any bearing on the hearing.

I have prepared a written statement that I would like to submit for the record and it includes my full support for your legislation.

Senator RIEGLE. We will make it part of the record.

Mr. SCHWAB. Thank you.

I am here today to represent the individual investor and I have to tell you that he is very angry, very angry indeed about what's going on on Wall Street. He's lost much of his confidence and faith in the fairness and the stability of the markets. He wants program trading stopped.

Our firm serves over 2 million customers from coast to coast. We as a firm provide no research or recommendations and no advice. We also don't do any program trading and we don't handle futures and we don't ever trade for our own account.

Our customers make their own investment decisions and they are the typical American individual investor. Our customers' transactions in equities since the market crash have dropped 30 to 40 percent since the crash. What we have observed among out customers is a migration from equities to debt and fixed income instruments, from a thought process of confidence to caution, a sort of movement from decisiveness to inaction.

In communication with our customers we hear over and over again the thing that the individual investor cannot compete in the markets while they are so dominated by the volatility introduced by program trading and index abritrage.

American investors want to see prices reflected through fundamental values. They don't believe that true values change by 23 percent on that one ugly afternoon on October 19. Before they will invest in America again they want to know what is causing the unreal price swings. But more importantly, they want to see something done about it to correct it.

MARKET MANIPULATION

Now in my view, the problem is caused quite simply by the modern high tech equivalent of our old nemesis called manipulation—market manipulation. Pools of capital moving in concert, utilizing high leverage through options and futures contracts managed by computer programs—these, gentlemen, are today's modern day manipulators.

In many cases, the money belongs to industry members putting powerful and profitable self-interest first. I believe they are abdicating their responsibility to provide orderly liquid markets so that American corporations can efficiently fund their endeavors and investors can make rational choices.

Now what can be done to restore order to our markets? What can be done to restore confidence to the American investor?

First, if we are going to maintain the various markets, stocks, futures, options, as one market—indeed they are connected and linked—we must have what your bill, S. 2256, sets out to provide. That's coordinated regulation, unified clearing systems, consistent margin requirements across all the markets, and I most certainly support the need for the so-called circuit breaker mechanisms.

Second, we need to abolish program trading entirely, at least until we are satisfied that the solutions are adequate to assure orderly markets. Maybe we could call a moratorium.

Late last week we surveyed 5,000 of our customers across the country from coast to coast that are currently active investors, and over 80 percent of them stated that they believed program trading is a major cause of recent market volatility and most said that they would have more confidence in the market as a safe place to invest if program trading were banned.

Third, we must give the Federal Reserve the power to control margins on options and stock index futures. As the overseer of our Nation's monetary system, the Federal Reserve must have the ability to control the synthetic forms of credit that exist in these markets now.

Fourth, I believe that until the council formed by this bill is satisfied with other controls there should be strict limits on the maximum spreads between the futures prices and the underlying stock indices. This particular circuit breaker would turn off the derivative markets trading before—I emphasize before—before the programs were triggered. Thus eliminating some of the incredible scary days when the maket is up 50 points or down 100 points the last half of the trading day. I feel strongly that circuit breakers should be applied first to the index futures markets. While the stock market itself is left to trade as a truly free market. This approach would prevent the tail from wagging the dog while reserving the truly American concept of free enterprise in our Nation's primary capital markets.

In finishing, we and our customers are vitally concerned with the fairness and stability of the market. We stand ready to help this committee or the new Intermarket Coordination Council to help them understand the concerns of the individual investor in any way that we can. And I thank you, Mr. Chairman, for the opportunity to speak on behalf of the individual investor and I would be glad to answer any questions that you might have.

[The complete prepared statement of Mr. Schwab follows:]

unhealthy Wall Street will sooner or later drag down the real economy.

There are those who argue that options and index futures are "just like commodities." This doesn't wash with me. Soybeans, wheat, cotton, and gold are real. You can't eat, or wear, stock indexes.

What's worse, these instruments have combined the worst features of stocks and commodities. They have low margin requirements, practically nonexistent in some cases, such as with options on options. On top of that, these instruments lack the price limits that are common in real commodities, and they permit short selling without up tick. No one can convince me that the ownership of an option on an index means you own the underlying securities, and thus are exempt from short selling rules.

And what has the reaction been from the regulators, and the various study groups that predictably have been commissioned? One recommendation, to curb program trading on days of wide market swings, was implemented a month or two ago. From what I've read, this "reform" *contributed* to the 100 point Dow plunge a couple of weeks ago. It's like teaching a child that it is OK to take someone else's candy -- but don't eat it all at one time; do it in several bites.

Another recommendation, to shut down markets in time of volatility, is both an invitation for speculators and an admission that there's something fundamentally wrong with our markets and what is permitted. This option always exists, of course, but to telegraph it invites trouble.

In my mind, we should *start* by banning index option arbitrage, and then proceed with other reforms which will restore *public* confidence in the financial markets. The public has every reason to believe the present game is rigged. It is. Many would be better off in the casinos, since there people expect to lose but have a good meal, and a good time while doing it!

I don't think it's too extreme to say that overall confidence in our free market *system* is threatened by this sort of scandal; and that's what it is -- a scandal.

To plagiarize and reverse Bert Lance's old saying, "If it's broke, fix it."

The stock and related markets *are* broken, and unless the industry and the regulating agencies get their acts together, you in Congress are going to have to re-regulate the industry. In my opinion, such legislation could wind up going too far, and the *hurt* the economy. But I, for one, won't blame Congress. If industry leaders don't act like statesmen in troubled times, they have no one to blame but themselves.

Thank you.

TESTIMONY OF

GEORGE L. BALL

CHAIRMAN AND CHIEF EXECUTIVE OFFICER
PRUDENTIAL-BACHE SECURITIES INC.

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

MAY 11, 1988

Thank you, Mr. Chairman, for the opportunity to appear here today. As you can imagine, our entire industry has been following the Committee's recent hearings with more than scholastic interest. Thus, the chance to participate in your widely - and correctly - admired efforts is deeply appreciated.

The following thoughts on the recent behavior of the markets, its impact on the capital formation process, and possible solutions, are those of an international, full-service firm with more than one million clients and some 17,000 employees. And, although the company I represent is more than 100 years old, the events that it, like others, has witnessed in recent months are without precedent.

Indeed, over the last quarter century, the financial markets have undergone dramatic expansion, creating a vast array of investment alternatives and attracting millions of new participants.

Unfortunately, while these developments have been, for the most part, salubrious, it's widely perceived that some of the U.S. equity market's basic strengths have peeled away like the skin of an aged 737. That's harmful.

For decades, there has been a justified belief that our nation's marketplace was a fair and equitable one for all participants, that it was liquid, and that it was a valid barometer of the confidence in the future of the nation's economy. It would be great if those beliefs still existed, but they don't.

In the Grave New World of 1988, most, even rational and

dispassionate observers seem to think otherwise.

That crisis of confidence actually began quite a while ago. However, with the destructive force of a Mt. Saint Helens, it was brought to an eruptive head by the Great Crash of 1987.

Nonetheless, by early January, some people were starting to believe that October 19th might have been just an actuary's once-in-a-century black hole -- that it was a one time phenomenon. Sadly, the market's 140 point plunge on January 8th proved that to be a pipedream. Prolonging the nightmare into a never waking tempest have been the continuing aftershocks--that is, the wild swings in the various market indices and the prices of their component stocks. And this manic-depressiveness is evidenced not just on a day-to-day basis, but on an almost hourly one.

You have heard a number of people voice their belief that the stock market has become a casino. Let me try to underscore the gravity of that perception. Our firm recently surveyed approximately 400 randomly selected investors. Chillingly, nearly half of those questioned felt that the stock market is no longer a place for the small investor and that program trading has disadvantaged them seriously. They feel cheated.

Similarly, just last week, in preparation for these hearings, we polled our salespeople to gauge their assessment of client sentiment. As feared, most of them said that excessive market volatility has made the public view investing in stocks as unwise and overly risky.

The upshot of these beliefs is that our nation is exposed to symptoms that go well beyond a traditional bear market bellyache. It could create economic chaos. Not only is trading volume down dramatically, but some professionals estimate that market liquidity has declined by more than half since October. Only a miniscule number of companies have been able to issue stock to finance their activities.

Should these conditions persist, the potential consequences for the country are quite unnerving. Investors will demand far higher risk premiums for owning stock. That will drive share prices lower than they would be otherwise, raising the cost of capital for an already debt-heavy nation and further undermining its international competitiveness.

Thus, extreme market volatility threatens to create destabilizing forces which could, in turn, cause a sharp recession or even a depression. What, then, is to be done to return some semblance of needed order? The Committee has heard numerous valuable suggestions, and the Chairman has offered legislation incorporating several of the best of them. Let me thus focus my commentary on a few rather different ideas, while reflecting briefly on the main components of the bill.

As a starting point, the focus on inter-market issues is correct. While trade figures and other indicators have been behavioral catalysts, the structural problems in the markets have little to do with economic fundamentals, which for the most part are strong. Rather, they appear to have almost everything to do with the shot-gun marriage of the stock and commodity markets through equity-related futures.

On that point, let me be precise. The stock market's excessive volatility results from its being driven by the commodity markets. In other words, the primary market has become the derivative. Like Alice peering through the looking glass, the futures tail is today wagging the stock market dog.

To be sure, commodity traders are accustomed to, and even search for, a high degree of volatility. But stock investors, who tend to have longer-term perspectives, are not. Seeking to paddle a canoe across a serene lake is one thing; being engulfed in shooting white water rapids is quite another.

This is not meant to deride the stock-index future. It was a well-intended and timely innovation that still possesses some conspicuous advantages for major portfolio investors.

However, we have to look at the needs of the nation's markets and the economy overall. In that context, the effect of the index future appears to us to argue against its continuance. Most knowledgeable professionals agree that, if it were not for index futures, stock market moves would be far less wild, sudden or irrationally large. Remember the physical properties of a ram jet engine: the faster it goes, the faster it goes. That, unfortunately, describes the equity arena today. It is fueled by the external and extraneous energy source of the index future.

The basic problem is not the closing of small gaps between a stock index future and its underlying securities, the so-called arbitrage function. Rather, the concern is that the two markets, once linked, can feed on one another, creating a cascading effect independent of any fundamental values. By eliminating that avalanching linkage, the slopes may be safe again, even for the novice.

Thus, one idea that merits inspection is the abolition of the stock index future altogether. That may seem to be a relatively radical notion for a free-market advocate to put forth. And we, for whom such a move would not be without painful short-term costs, are not today suggesting it per se. But these are highly unusual times, ones that call for unusual initiatives. Certainly, many investors, large and small, would applaud the abolition of the stock-index future. Indeed, it's believed that many stock traders were happily smitten with a pleasant sense of nostalgia last week when a flood stopped trading at the Chicago Mercantile Exchange, the market for the S&P 500 index future. One might have called it the ultimate circuit-breaker.

Short of mandating floods or killing index futures, it might be constructive to place position limits on them. Presently, in terms of dollar-equivalency, the cap per client on holdings of stock-index futures contracts is three times the limit on index options. It might be smart to reduce the former to the option ceiling; the stabilizing effect would be enormous. It's been argued that globalization makes a move of this nature impractical. That's not right. It is within the present powers of legislators and regulators to prevent users of these instruments from eluding limits by going overseas. The proper rules, while somewhat technically difficult to draft, can be constructed and are enforceable.

An alternative suggestion along a similar track would be to impose a limit on the dollar value of index contracts that could be traded by any single entity in a day. Perhaps a $75 million limit for all index products combined would be appropriate. Basically this proposal is a response to the concerns the Chairman has articulated about potential market manipulation and could be of real value. By curbing the influence of any one factor on a given day, one could obviate the ability of a superpower to damage the share prices of America's leading companies.

As a final potential initiative, an experiment whereby index futures trading was limited to three or four hours a day might be worth considering. As you can appreciate, a step like this could provide a very useful laboratory for investigation, although the time needed to diagnose the stress fractures might be unduly long in light of the number of impending landings.

In any event, these are a series of initiatives we have under study. They seem to deserve the attention of those who can bring about rule and regulatory change.

Beyond that, many of the solutions that Chairman Proxmire has proposed deserve widespread support. To begin with, harmonizing margin requirements across markets, with the point of harmonic convergence to be determined by federal regulators, is crucial. Undoubtedly, the higher leveraging allowed in the future markets has permitted legitimate, if unfortunate, circumvention of Regulation T and has thus made index futures an economically advantaged surrogate for investing or speculating in the stock market. As we all know, other things being equal, capital will gravitate to the instrument that offers the greatest leverage.

That leads to the issue of who should oversee policy. We agree that a new agency per se seems redundant; the relevant issues can be handled effectively within the existing regulatory matrix. But on issues as sweeping as leverage, circuit-breakers or linkage, sure-handed inter-agency coordination is imperative. Thus, our firm would strongly support legislative mandates that bring about on-going coordination, establish a substantive agenda, and set a time-table for a response to Congress or the President.

Of course, over the short-term, the actions suggested above would hurt my firm, like others, where it hurts most--on the bottom line. For example, last year we received more than $15 million in revenues from stock-index futures and the like. That is not a pittance.

But liberating the stock market from the air pocket-like turbulence of the commodity markets is imperative. Doing so will help to restore investor confidence in the market, lift stock prices, ward off structurally caused economic disaster and improve the long-term vitality of our nation's capital formation process.

Thank you very much.

Senator **Reigle**. Gentleman, thank you for your statements. I am struck by several things that each of you said. I think I'm perhaps most struck by the fact that you all have lifetime reputations as free market advocates and are very much of that view. It's been your personal history, your professional history, and yet you are all of the mind in saying that the free market system, if we can call it that at the moment, in the financial market structure is not working properly and that you're alarmed about it and you've been very blunt in saying so in your testimony.

Mr. Regan, you say—and I'm quoting you—"the present game is rigged and we should start by banning index arbitrage and then proceed with other reforms." Mr. Ball, you state that "there is a crisis of confidence and that there should be the abolition of the stock index futures altogether." And Mr. Schwab, you speak of "market manipulation and pools of capital moving in concert," and you suggest a number of things which you've just finished mentioning.

I'd like to get a sense, if I may—I'd like to try to understand how people like yourselves who are top professionals and who are strongest advocates of the free market system are there today saying that that system really isn't working properly and that there are dangers that you see unless some change is made, some structure put in place, some law, some regulation, some restraint.

It seems to me that, given your long histories, that that really is quite a striking thing to have you come and say that to us now and I'd like to just understand better how it is that people like yourselves have come to such a sense of concern that you're here saying that the free market system really isn't working properly.

FREE MARKET ISN'T WORKING PROPERLY

Mr. **Regan**. Let me take a swing at it first, Senator.

Obviously, I didn't consult with these two other gentleman who I have known from the industry, since I am a "has-been" if you will as far as the financial industry is concerned. But based upon my experience, not only as having been 35 years in Wall Street but then as Secretary of the Treasury watching our free markets, I'm jealous of the fact that they have to be guarded and I'm very conscious of the fact that we now have an innovation that's been introduced into this market which is not making it a free market any longer.

We talk about efficient markets and so forth and yet we allow a group of commodity traders to set up their own apparatus to trade securities in a fashion that was never concerned before for their own benefit.

Now once they set that up, others came in and thought of the possibility of, well, maybe this is insurance we could use; that it, if we're long with stocks we can short the future and therefore we're partially protected. There are other ways to accomplish that in the stock market of shorting one stock when you're long in another. There are many techniques that can be used apart from that type of insurance trading.

But then came the real—what will I say—factor that has led to this sense of individuals that they can't compete. They're thinking in terms of an IBM machine or a Control Data machine programmed by 50 to 100 experts to automatically come up with a market strategy and then they think, poor me, all I can do is read the publications, talk to my broker, I don't have that degree of sophistication; I can't win; I'm backing out. I'm throwing my cards in. I can't sit in on this game.

Now if that happens, what do we get to? We get to a completely institutionalized market. They had that in London years ago. It was not a reflective market of the British economy or British companies. We have that at risk here in our situation where instead of individuals owning their own share of American industry, we have American industry being owned by only institutions who are middlemen between the individual and the corporation. As a result of that, we don't get true corporate earnings power reflected in the pricing mechanism.

I agree with what Senator Gramm said, that we cannot allow us to try to tinker with the mechanism in order to get or to change underlying fundamentals, but that's my point. I don't think underlying fundamentals changed last October. This was a false thing introduced and therefore I think that false thing is the thing which should be taken away from the market system and banned.

Mr. **Ball**. It seems to me that the crash of last October was a frightening event. It was in large part inexplicable if taken in isolation. The investors today are simply waiting for something like it to happen again. They think that it will, and they're probably right. I'm a former governor of two of the options exchanges and a great supporter of commodity markets, and yet something has changed which we need to recognize. Unfortunately, for the time being, technology has run ahead of the ability of even literate human beings to keep up with it. So we need to do something to redress it.

At this point the potentially economically destabilizing impact of program trading combined with portfolio insurance could create what in the olden days was known as a finanical panic. I think, the last one our country had was in 1906 and 1907. But if we do get one, which is a run on the bank with the bank now being the equity markets, it would create a devastation within the Nation's economy that we simply can't let happen.

So above and beyond protecting the equity markets, where I certainly share the Secretary's viewpoint, I think we have to protect the economy of our country.

Senator **Riegle**. Mr. Schwab.

Mr. **Schwab**. Just a couple of comments, First of all, we should understand that 62 percent of equities or stocks are owned by individuals, and as we mentioned and testified, they are very scared about many of these things that are unknown. The players in the whole area of the sophistication that we're speaking about today is a very small number. It's probably a few hundred at the most as compared to maybe 25 to 50 million, depending on what number you use, in terms of how many investors are out there in the marketplace. I simply think we need to put some kind of wrap, a moratorium for awhile, on this area, measure it, monitor it, and let it maybe come back in slowly, but don't let it ruin the whole thing for the masses of us.

Senator RIEGLE. Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I think you may have said that there are some chilling testimony that was submitted today. I would submit that that chilling testimony goes far beyond this room, that it is a very real condition that exists.

Don Regan, I was going to ask before he said it, have you spoken to any one of your colleagues at the table and he indicated that he hadn't. And yet coming from someone who is not directly in Wall Street today but had been there for many years and then served as Secretary of the Treasury, coming from Mr. Schwab, who represents in his company 2 million small investors, coming from Mr. Ball, who represents one of the great investment banking houses and whose company itself has made some $15 million on the futures indices—we hear there is a core that they have identified—the three of them—as the dilemma. It's not the computer. It's not the use of modern technique. You're not suggesting abandoning that, are you, any of you? Rather, the market manipulation that is open and obviously in their opinion been exploited to some extent—Mr. Schwab has been more explicit by saying several hundred money managers, et cetera—are in a position to exploit this system where tens of millions are involved.

I, for one, think that it might profit this committee to have the opportunity in more than just a 5-minute or 10-minute answer, and I think that these distinguished gentlemen would need more time to explain exactly—and I'm going to ask if you would attempt this—how it is that this index arbitraging can bring about the volatility and the potential for exploitation? I, for one, really don't know, I don't think the media knows. I certainly don't think the general public knows. I wonder how many people down on Wall Street in day-to-day activities know.

George, could you attempt—or, Mr. Regan or Mr. Schwab?

INDEX ARBITRAGING

Mr. SCHWAB. I would just venture one comment, that on the ugly day of October 19, we had a panic going on. There was $20 billion worth of securities sold and there was approximately—it's hard to believe but I found this out from the Brady Commission task force report—$20 billion of the S&P futures contracts were sold on a margin of maybe 4 or 5 percent.

Now tell me, that is what I call leverage in the most dramatic sense, way beyond what we ever learned from our experiences in 1929 to 1933.

Mr. BALL. From a mechanical standpoint, just in 20 words or less, when a stock index future is selling at a discount from the actual price of its underlying stocks, the intelligent arbitrageur will sell the stocks, getting $10,000 and buy the corresponding index future contract, let's say hypothetically for $9,000. My numbers are extreme. This clearly creates downward pressure on the stocks. By the way, it can work the other way around, Senator, but I'm using the down example because it's the more lurid.

In and of itself, that is apt to create an equal and offsetting event within a day or two. However, those who are using index futures and arbitrage for insurance purposes, as they see their stocks decline in value, will then sell the index future as their insurance policy. That creates the same spread again, causing people to once again sell the stocks and to buy the index future. Thus, the problem is not only the volatility, but it's avalanching. Its cascading. That's what's so frightening. This is a purely innocent event, but the combination of indexes and portfolio insurance put together in a benign fashion by computers has brought about a consequence that nobody dreamed of. There is not a fault to be found. It's just something that created a confluence that is potentially economically ruinsome.

When these things start to work together and start to cascade, the intelligent market maker—the specialist on the floor of the New York Stock Exchange—sees what's happening. He sees this great pipe that's starting to send a flood of orders to him and what he or she does is to back way away, thereby pulling the markets down even further causing the cascade to feed further on itself.

So that is the ultimate destabilization. Index arbitrage creating sales by portfolio insurers where market makers seeing this great tide of orders coming through them back away to the hilt. Again, I'm not faulting anybody in that, but it's just simply three things that nobody expected to interact, but if they are the wing of an airplane I would not want to be flying on the airplane.

Senator D'AMATO. Hence, your description that the primary market then becomes a derivative, it's kind of the tail on the dog.

Mr. BALL. Yes, sir.

Senator D'AMATO. Reacting to these events.

Mr. Chairman, I would submit that this is rather chilling. We are hearing from experts and I think it's not going to be easy but it's going to be incumbent upon us to address that situation or to have the exchanges and the various boards and institutions undertake to do that voluntarily, but certainly the confluences of circumstances that brought about the incredible downward market in October and to a lesser extent in January, they are still out there. Isn't that right?

Mr. REGAN. Absolutely.

Senator D'AMATO. And they're going to come together. I think we would be doing a great disservice—and it's not this legislation that's before us that's going to answer that question. That's not going to answer the question. I think we'd better begin to deal in some detail as to what to do, whether it is to put the pressure on the SEC and the commodities people and some of the others to get some voluntary action or to get some legislative action and that doesn't mean another commission.

I've gone beyond my time, but I want to thank the panel. I think all three of them have done a great, great public service in coming forth and giving testimony today. Thank you.

Senator RIEGLE. Thank you.

Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman.

Gentlemen, thank you for your good testimony this morning. Let me in the short time that I have see if we can go back to basics because I think that's what the three of you are getting at.

Presumably, what we're about in this committee and in these markets is to assure that we maintain markets which have been enormously successful in raising capital and sustaining liquidity. Second, our job is to make sure that these markets are governed in such a way that the small investor in particular feels that he or she can participate. They need to be treated fairly so they will take that capital out from under the mattress and put it in the market and have it work. Those are the two goals that we have continued to espouse over the 50 years that we've had regulation in this area.

In 1982, again going back to basics, we had a set of hearings I think on both sides of the Hill but I remember them particularly on the House side—we had a set of hearings on stock index futures. This was before they even existed. And we asked a number of questions about these instruments, based upon a number of questions related to our goals in the Congress and in the government as they relate to the market.

The three questions that came out at the time—this was when we were reviewing the Shad-Johnson accord—you will remember, the relationship between the SEC and the CFTC the accord reached by Chairman Shad and Chairman Johnson. We asked three questions. How might the advent of stock index futures affect capital formation? Could these instruments allow greater manipulation in some markets that could spill over into the securities area? And would low margin requirements provide for a lot of increased speculation in the marketplace?

We asked those three questions of all the witnesses, including Chairman Shad, Chairman Johnson, and a variety of witnesses—experts in the area.

All of them told us that the new instruments would be OK and not to worry. We heard that uniformly from Shad, Johnson, the Department of the Treasury witnesses, the administration people, experts from Wall Street. They all said, "No problem. These instruments will provide liquidity, will help us raise capital, and will provide the ability to hedge."

So we went ahead based upon the best knowledge that we had to at that point. Now it seems to me that the answers those to fundamental questions ought to be reviewed again; that when we asked the question about affecting capital formation, the answer was "no problem." But since October we have seen that there's been a great skittishness about bringing out any new issues at all and I would think that there has been a problem affecting capital formation.

Second, manipulation that could spill over into markets, the Brady Commission said that they are clearly linked and all of you have suggested that this morning.

Third, looking at margins, we've seen a great deal of activity and you just noted that, Mr. Ball, in your answer to Senator D'Amato's question about the 4 or 5 percent against $20 billion.

Now if this is the case, maybe we ought to be going back and going right to basics to define what we're about, what we're trying to do, how these instruments impact upon this marketplace. We were told in 1982 before the instruments were brought on that they would be healthy and good, but maybe they haven't been. Maybe that suggests that we ought to go back and look at the instruments altogether.

I'm just trying again to go right back to the roots of what we're about and where we're going. That is in the way of a question to

The
Charles
Schwab
Corporation

TESTIMONY OF CHARLES R. SCHWAB
CHAIRMAN AND CHIEF EXECUTIVE OFFICER,
CHARLES SCHWAB & CO.
BEFORE THE UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

MAY 11, 1988

THANK YOU, MR. CHAIRMAN, AND MEMBERS OF THE COMMITTEE. I AM CHARLES SCHWAB, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER OF CHARLES SCHWAB & COMPANY. I APPRECIATE THIS OPPORTUNITY TO TESTIFY ON A TIMELY AND IMPORTANT PIECE OF LEGISLATION, THE INTERMARKET COORDINATION ACT OF 1988.

IT IS AN IDEA WHOSE TIME HAS COME, AND I SUPPORT IT BECAUSE OF THE IMPACT BLACK MONDAY HAD ON THE ATTITUDES OF INDIVIDUAL INVESTORS TOWARD THE NATION'S CAPITAL MARKETS. I WOULD ALSO LIKE TO EXPRESS THE APPRECIATION OF THOUSANDS OF INVESTORS ACROSS THE COUNTRY FOR YOUR LEADERSHIP ON THIS ISSUE.

OURS IS THE NATION'S LARGEST DISCOUNT BROKERAGE FIRM. WE GIVE NO ADVICE, NO RESEARCH, NO RECOMMENDATIONS: AND WE NEVER TRADE FOR OUR OWN INVESTMENT ACCOUNT. OUR CUSTOMERS MAKE THEIR OWN INVESTMENT DECISIONS, AND WE EXECUTE THEIR ORDERS AND PROVIDE CUSTODY FOR THEIR ASSETS, CHARGING COMMISSIONS ABOUT FIFTY PERCENT BELOW THOSE CHARGED BY FULL COMMISSION FIRMS.

WE SERVE OVER TWO MILLION CUSTOMER ACCOUNTS, OF WHICH ABOUT ONE MILLION TRANSACT BUSINESS WITH US IN ANY YEAR. LAST YEAR WE EXECUTED APPROXIMATELY SEVENTEEN THOUSAND TRADES PER DAY AT AN AVERAGE OF ABOUT NINE THOUSAND DOLLARS PRINCIPAL AMOUNT PER TRANSACTION. OUR CUSTOMERS HAVE ABOUT SIXTEEN BILLION DOLLARS WORTH OF ASSETS IN THEIR ACCOUNTS WITH US.

THOUGH WE SPAN THE ENTIRE RANGE OF INDIVIDUAL INVESTORS, OUR AVERAGE CUSTOMER IS MALE, IN HIS LATE FORTIES, AND HAS A HOUSEHOLD INCOME OF FIFTY TO SIXTY THOUSAND DOLLARS AND TOTAL INVESTMENT ASSETS OF LESS THAN ONE HUNDRED THOUSAND DOLLARS. IN SHORT, HE IS THE TYPICAL AMERICAN INDIVIDUAL INVESTOR.

LATE LAST WEEK, IN PREPARATION FOR THIS HEARING, WE CONDUCTED A SURVEY OF OUR CUSTOMERS. THE SURVEY - THE COMPLETE RESULTS OF WHICH ARE ATTACHED - CONFIRMED WHAT WE HAVE HEARD REPEATEDLY SINCE THE MARKET CRASH LAST FALL.

MR. CHAIRMAN, THE INDIVIDUAL INVESTOR IN THIS COUNTRY IS ANGRY. HE IS ANGRY ABOUT WHAT HAPPENED TO HIM LAST FALL. HE IS ANGRY ABOUT THE VIOLENT MARKET SWINGS HE HAS SEEN SINCE THE CRASH. MOST OF ALL, HE IS ANGRY ABOUT WASHINGTON'S FAILURE TO ENACT REFORMS NEEDED TO PROMOTE GREATER STABILITY IN THE SECURITIES MARKETS.

IN SHORT, HE EXPECTS HIS ELECTED REPRESENTATIVES TO MAKE A FEW CHANGES.

HE HAS LOST MUCH OF HIS FAITH IN THE FAIRNESS AND ORDERLINESS OF OUR MARKETS. OUR BUSINESS STATISTICS BEAR WITNESS TO THIS. OUR DAILY TRADE COUNT SURGED FROM SEVENTEEN THOUSAND PER DAY TO A PEAK OF OVER FIFTY THOUSAND IN THE WEEK OF OCTOBER 19TH. SINCE THAT TIME, THE LOSS OF INVESTOR CONFIDENCE HAS CAUSED THIS NUMBER TO DROP SHARPLY, TO ABOUT TEN TO

TWELVE THOUSAND TRADES PER DAY, WITH SOME DAYS AS LOW AS EIGHT THOUSAND. IN OUR FIRM, THIS HAS OCCURRED EVEN THOUGH CUSTOMER ASSETS IN SCHWAB ACCOUNTS HAVE BEEN STEADILY INCREASING SINCE THE CRASH.

WHAT WE HAVE SEEN IS A MIGRATION - A MIGRATION FROM EQUITY ASSETS TO FIXED INCOME AND MONEY MARKET ASSETS - FROM CONFIDENCE TO CAUTION - AND FROM DECISIVENESS TO INACTION. IN SURVEYS WE HAVE CONDUCTED, WE HEAR OVER AND OVER AGAIN THE THEME THAT INDIVIDUAL INVESTORS FEAR THEY CANNOT COMPETE IN MARKETS THAT ARE SO DOMINATED BY THE VOLATILITY INTRODUCED BY PROGRAM TRADING AND INDEX ARBITRAGE.

AMERICAN INVESTORS WANT TO SEE STOCK PRICES REFLECT FUNDAMENTAL VALUE. THEY DO NOT BELIEVE THESE TRUE VALUES CHANGED BY TWENTY-THREE PERCENT ON THE AFTERNOON OF OCTOBER 19TH. THEY SEE THE BIG MARKET SWINGS AS THE MODERN, HIGH-TECH EQUIVALENT OF OUR OLD NEMESIS, MARKET MANIPULATION. ORDINARY INVESTORS FEAR THEY ARE AT THE MERCY OF A SMALL CADRE OF WALL STREET PROFESSIONALS. ORDINARY INDIVIDUAL INVESTORS STILL RELY ON TRADITIONAL INVESTMENT TOOLS, BUT THE ARBITRAGEURS USE COMPUTER AND TELECOMMUNICATIONS NETWORKS THAT GIVE THEM NOT JUST AN ADVANTAGE, BUT A LOW-RISK LOCK ON PROFITS.

WHAT WE ARE SEEING IS A FINANCIAL MARKET VERSION OF "DR. STRANGELOVE." POOLS OF CAPITAL ARE MOVING IN CONCERT, UTILIZING HIGH LEVERAGE THROUGH OPTION AND FUTURES CONTRACTS. BUT THE BRAINS BEHIND THESE ACTIONS ARE NOT HUMAN. THEY ARE COMPUTER PROGRAMS.

IN MANY CASES, THE MONEY BELONGS TO FIRMS IN THE SECURITIES INDUSTRY. I BELIEVE THEY ARE ABDICATING THEIR RESPONSIBILITY TO PROVIDE ORDERLY LIQUID MARKETS. WITHOUT THEM, AMERICAN CORPORATIONS CANNOT EFFICIENTLY FUND THEIR ENDEAVORS. YET BY ALLOWING PROGRAM TRADING TO CORRUPT THESE MARKETS SO RAMPANTLY, THESE FIRMS HAVE RAISED THE COST OF EQUITY CAPITAL FOR AMERICAN COMPANIES BY AS MUCH AS TWENTY OR THIRTY PERCENT.

BEFORE THEY WILL INVEST IN AMERICA WITH CONFIDENCE AGAIN, INVESTORS WANT TO KNOW WHAT IS CAUSING THIS PROBLEM, BUT MORE IMPORTANTLY, THEY WANT TO SEE SOMETHING DONE TO CORRECT IT.

CERTAIN STEPS CAN BE TAKEN TO RESTORE ORDER TO OUR MARKETS AND CONFIDENCE TO THE AMERICAN INVESTOR. I'D LIKE FIRST TO COMMENT ON THE IMPRESSIVE WORK OF THE BRADY COMMISSION AND ON ITS RECOMMENDATIONS. PERHAPS IT IS UNNECESSARY TO REPEAT THEM, BUT IF WE ARE GOING TO MAINTAIN THESE VARIOUS MARKETS, WE MUST HAVE WHAT YOUR BILL SETS OUT TO PROVIDE - COORDINATED REGULATION, UNIFIED CLEARING SYSTEMS AND CONSISTENT MARGIN REQUIREMENTS ACROSS ALL MARKETS. AND I MOST CERTAINLY SUPPORT THE NEED FOR SO-CALLED CIRCUIT BREAKER MECHANISMS.

I PERSONALLY BELIEVE THREE OTHER STEPS ARE VITAL TO RESTORING CONFIDENCE IN OUR MARKETS. FIRST, ADOPT LEGISLATION AUTHORIZING AND REQUIRING THE FEDERAL RESERVE BOARD TO SET MARGIN LEVELS FOR STOCK OPTIONS AND FOR STOCK INDEX FUTURES. BECAUSE THE DEFINITION OF SECURITIES FOR

PURPOSES OF FEDERAL LAW DOES NOT INCLUDE STOCK INDEX FUTURES, THE AUTHORITY TO SET INITIAL AND MAINTENANCE REQUIREMENTS IS NOT GRANTED TO THE FEDERAL RESERVE BOARD BY SECTION 7 OF THE SECURITIES EXCHANGE ACT OF 1934. AS THE OVERSEER OF OUR NATION'S MONETARY SYSTEM, THERE IS EVERY THEORETICAL AND PRACTICAL REASON TO EXTEND THE FEDERAL RESERVE'S AUTHORITY TO CONTROL CREDIT TO THE SYNTHETIC FORMS OF CREDIT EXISTING IN OPTION AND FUTURES TRADING.

SECOND, ABOLISH PROGRAM TRADING ENTIRELY, AT LEAST UNTIL WE ARE SATISFIED THAT OTHER SOLUTIONS ARE ADEQUATE TO ENSURE ORDERLY MARKETS. IN A SURVEY OF FIVE THOUSAND OF OUR CURRENTLY ACTIVE CUSTOMERS CONDUCTED LATE LAST WEEK, AFTER I WAS INVITED TO TESTIFY AT THIS HEARING, OVER EIGHTY PERCENT SAID THEY BELIEVE PROGRAM TRADING IS A MAJOR CAUSE OF RECENT MARKET VOLATILITY. FORTY PERCENT BELIEVE LEGISLATION IS NECESSARY TO SOLVE THESE PROBLEMS, AND SIXTY PERCENT BELIEVE THAT THE ELIMINATION OF PROGRAM TRADING WOULD INCREASE THEIR LEVEL OF CONFIDENCE IN THE STOCK MARKET AS A SAFE PLACE TO INVEST. PLEASE REMEMBER THAT THESE ARE THE OPINIONS NOT OF THOSE PEOPLE WHO HAVE ALREADY LEFT THE MARKET, BUT OF THOSE WHO ARE STILL TRADING TODAY. I SHOULD ADD THAT EVEN OF THESE HARDY SOULS, ALMOST FORTY PERCENT BELIEVE THAT IF PROGRAM TRADING WERE TO BE ELIMINATED OR SUBSTANTIALLY CONTROLLED, IT WOULD LEAD TO AN INCREASE OF THEIR ACTUAL LEVEL OF INVESTMENT IN THE STOCK MARKET.

THIRD, I BELIEVE UNTIL WE ARE SATISFIED WITH OTHER CONTROLS, THE COMMITTEE FORMED BY THIS BILL SHOULD IMPOSE STRICT LIMITS ON THE MAXIMUM SPREAD AT WHICH THE FUTURES MARKET CAN TRADE ABOVE OR BELOW THE CASH PRICE FOR STOCKS AND INDEXES. THIS PARTICULAR CIRCUIT BREAKER COULD TURN-OFF DERIVATIVE MARKET TRADING BEFORE PROGRAMS WERE TRIGGERED, SO THAT EVEN THOSE WHO MIGHT FIND A WAY AROUND THE ABOLITION LEGISLATION I'VE RECOMMENDED WOULD HAVE VERY LITTLE OPPORTUNITY TO EXERCISE THEIR SCHEMES PROFITABLY.

I FEEL STRONGLY THAT CIRCUIT BREAKERS SHOULD BE APPLIED FIRST TO THE INDEX FUTURES MARKETS WHILE THE STOCK MARKET ITSELF IS LEFT TO TRADE AS A TRULY FREE MARKET. THIS APPROACH WOULD PREVENT THE TAIL FROM WAGGING THE DOG, WHILE PRESERVING THE TRULY AMERICAN CONCEPT OF FREE ENTERPRISE IN THE NATION'S PRIMARY CAPITAL MARKET.

WE AND OUR CUSTOMERS ARE VITALLY CONCERNED ABOUT THE FAIRNESS AND STABILITY OF THESE MARKETS. WE STAND READY TO HELP THE COMMITTEE IN ANY WAY WE CAN. WE WOULD BE DELIGHTED TO PREPARE SURVEYS RAPIDLY TO ANSWER ANY ADDITIONAL QUESTIONS YOU MAY HAVE ABOUT THE ATTITUDES AND OPINIONS OF AMERICAN INVESTORS IN THESE UNCERTAIN TIMES.

I THANK YOU FOR THE OPPORTUNITY TO SPEAK ON BEHALF OF THE INDIVIDUAL INVESTOR. I WILL GLADLY ANSWER ANY QUESTIONS YOU MAY HAVE.

EXHIBIT A

Charles Schwab
Customer Survey on Program Trading
May 5-6, 1988

Immediately following the Committee's request for testimony at this hearing, we surveyed approximately 5,000 customers at 108 branches across America during a 48 hour period. We talked to individual investors who are still active in the market.

1. Do you believe program trading is a major cause of stock market volatility?

YES:	3,973	80%
NO:	909	18%
DON'T KNOW:	94	2%
TOTAL RESPONSES:	4,976	100%

2. Do you think that the securities industry will be able to solve the problem of market volatility on its own or is legislation necessary to solve this problem?

SECURITIES INDUSTRY CAN SOLVE:	2,788	57%
LEGISLATION IS NECESSARY:	2,005	41%
DON'T KNOW:	72	1%
TOTAL RESPONSES:	4,865	100%

3. If program trading were to be eliminated or substantially controlled, would it increase, decrease or not affect your level of confidence in the stock market as a safe place to invest?

INCREASE:	2,948	61%
DECREASE:	340	7%
NOT AFFECT:	1,568	32%
TOTAL RESPONSES:	4,856	100%

4. If program trading were to be eliminated or substantially controlled, would it increase, decrease or not affect your actual level of investment in the stock market?

INCREASE:	1,935	40%
DECREASE:	282	6%
NOT AFFECT:	2,615	54%
TOTAL RESPONSES:	4,832	100%

5. Aside from program trading, would you feel more confident if all trading activity in stock index futures were to be prohibited?

YES:	1,682	35%
NO:	3,071	64%
DON'T KNOW:	63	1%
TOTAL RESPONSES:	4,816	100%

the three of you. Should we be going back and reviewing these again? Were we wrong when the testimony came up in 1982 not to worry about these to go ahead with their offering?

NEED FOR REVIEW

Mr. **Regan**. Well, as you know, Senator, better than I, many times when you start with something new and innovative, particularly in the financial markets, you're in unchartered waters.

From the studies that had been made of stock indexes, trading them as futures, it seemed at that time that they would be a good feature. It has turned out, however—and particularly in light of October 1987—that there are imperfections in these instruments and that's why I'm suggesting that we halt trading in these instruments until we can get back to the basics and take another look at them and whether or not there are other types of instruments or other regulations we can put on these instruments to do it. But to allow the situation to exist, particularly as has been demonstrated from the statistics of my two colleagues here, is really—you're in a threatening position. If something untoward happens, the blame then will fall on those who could have been doing something but didn't, and I include in that Wall Street and the regulators.

Senator **Wirth**. I appreciate the answer. I think we did the best we could in 1982 and it looked like a good idea, but now based upon those various assumptions maybe we ought to be going back, as you suggest.

Let me ask Mr. Ball and Mr. Schwab for your answer.

Mr. **Schwab**. I think that's a very good idea and a very sound idea, to review the whole proposition of how we got into this situation and I think some of my testimony and the rest calls for some moratorium on some of these things to let us study further.

There are a couple of things that I think are fairly important in my mind that have come up that have led to some of these abberations. This concept of portfolio insurance, it's a wonderful idea to insure your portfolio. You can do it with your automobile. You can do it for fire insurance. You can do it for earthquake insurance. These happen to deal with isolated instances out there in the world.

Now when the market is smooth, they all move in the same direction, up or down generally speaking. So it's sort of a ridiculous concept to have portfolio insurance being the driving force. If everybody had their portfolio insured out there, what kind of insurance is that? We know markets would move up 10 percent or 20 percent or down on the same day. It's really a sort of a concept that I think has been oversold and led some people to some false security.

Another area in terms of the basics is this in-kind settlement. It's the only commodity that I'm aware of that settles in cash only. I think that has led to some great lack of discipline in the marketplace. You can settle in kind with cotton or corn or porkbellies, but you can't do it in stock indices. You can only do it in cash. So we have seen this tremendous abberation and illiquidity that occurred on October 19 both in the futures indices and in the options area and it has led to some very massive problems for individual investors in particular and I'm sure for institutional investors also. But I think we should go back to the basics, Senator.

Mr. **Ball**. At the time of the hearings that you mentioned, Senator, the decision to proceed was a correct one based on what people knew then. There was not the gleaning of portfolio insurance. The concept has developed since then and portfolio insurance is only a means of owning fewer and fewer stocks the lower and lower stock prices go. That's basically all that it is.

The development of these derivatives serves even today some social value. There is a nice idea to think that you can hedge risks on a very quick, efficient fashion. Unfortunately, the coming together of the thin margins, of the ability to arbitrage, and of the massive amount of people seeking protection, albeit spuriously, through portfolio insurance has created a major destabilizing element that outweighs—I think by a wide margin—even the important, still lingering economic or social benefits of the index future.

Senator **Wirth**. Thank you, Mr. Chairman.

Senator **Riegle**. Senator Hecht.

Senator **Hecht**. Thank you, Mr. Chairman.

First of all, Mr. Regan, I do want to thank you for mentioning that people would be better off in the casino, since I'm from Nevada and I have a small interest in five hotels and I certainly agree with you. I don't know anyone in the 40 years I've been in Las Vegas who's ever lost any money. [Laughter.]

Everyone wins out there. You're absolutely right.

Let me put this on a different tack, though. You know you're from big companies. My own opinion is all of you had very little to do with this. Let's get back and read the newspapers a month before the October crash. What was going on in America? The Republicans lost control of the Senate. Everyone was concerned. We had a trade bill on the horizon. Everyone was talking about higher interest rates, had to go back to higher interest rates when we couldn't do anything but raise taxes and then we had to raise taxes, and then inflation was going to go up. Then there was legislation that was very antibusiness. Minimum wages, they were pushing at that time. Mandated health benefits. We were going to cut defense, cut research. Judge Bork, one of the most competent men ever to come before the U.S. Senate was turned down. President Reagan seemed to be losing his power. He couldn't control the Senate. People lost confidence. As I mentioned to Mr. Regan, I'm part of five hotels. We probably have between 7,500 to 8,500 employees. They asked me what's going to happen to our bottom line if these things happened? I said, "What bottom line are you talking about? You don't have a bottom line if these things happen." All of a sudden people lost confidence.

LACK OF CONFIDENCE IN MARKET

That's what the stock market is about—confidence. How are you going to buy stock in a company if the next year we have a fantastic profit and you're going to show a loss? This is what I'm trying to bring out. With all these terrible things that's happened we've got ourselves back together again. The first 4 months of this year, there are more people working than were working before. We've got 16 million more Americans working. This is what confidence is all about. I don't know of one person I have ever met out of hundreds of thousands that ever bought a stock because of computer or program trading, but I do know they bought it because it's a good company and it's going to make a lot of money and everything is in that direction.

Now do you think what I have said has any relevance?

Mr. **Regan**. It certainly has relevance, Senator, but it goes back to the point made by your colleague, Senator Gramm, a former professor of economics, should understand these things a lot better than some of us novitiates, but from the point of view of basic underlying economics, there were worries in the fall of 1987. People were worried as to whether or not the current expansion would continue. Most economists were wrong then, with all due respect to your colleague Senator Gramm. They were wrong in their predictions, but they had the marketplace worried. Selling did come in a week before October 19. There were many down days in that period. I'm not sure it was five out of five but certainly four out of five.

Now what happened, though—and that's the thing that I'm railing against—this was exacerbated by your index arbitrage and program trading. Perhaps the market might have gone "x". I don't know. I was trying to look up some material and I can't lay my hands on it, but I think one of the studies of October 19 indicated that the market probably went off an extra—I don't know—30, 40, 50 percent because of program trading. That's what I'm against. I don't believe you can stand like King Canute and hurl the waves back, but you sure as heck don't have to create more waves by an artificial device.

Senator **Hecht**. But the market, as you mentioned, in the paper, five companies are stopping program trading. They're working that out.

Mr. **Regan**. But they are only a small portion of the trading.

Senator **Hecht**. The public is going to go where they have confidence.

Mr. **Regan**. If this can be done without congressional interference, I would applaud that even more. That's what I'm calling for—leadership by Wall Streeters. Do away with it themselves and not just Wall Street, LaSalle Street also.

Senator **Hecht**. How do you feel, Mr. Schwab? You mentioned my distinguished colleague. He has a Ph.D. from many universities. I have a Ph.D. from the school of hard knocks.

Senator **Gramm**. And you have money, which is the final index. Don't ever forget that. [Laughter.]

Mr. **Schwab**. Senator, it's my feeling that this bill here is not an issue toward regulating up markets or down markets, bull markets or bear markets. We will have those. We have had them for hundreds of years and we will have them for hundreds of years in the future.

We are talking about this exacerbated situation caused by these new instruments that need to be put under control. In our view, in our research, the individual investor out there clearly has not lost confidence in the economy. He's lost confidence in the market mechanisms. That's what we're talking about here. How can we bring some sense to abberant behavior for a good period of time, study it, put it under a moratorium and then maybe phase it back in under some beginning pilot kind of ways.

Mr. **Ball**. Other than the dubious joy of hearing my own voice, Senator, I have nothing to add to these two learned gentlemen's comments on this particular issue.

Senator **Hecht**. Thank you very much.

Senator **Riegle**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

There's been some confessions already here today. My friend, Senator Wirth, confessed that maybe in 1982 he didn't probe hard enough. We've all confessed some responsibility for what has transpired. Senator Sanford and I want to confess that we were elected in November 1986 and we contributed to that change of a majority in the Senate and if we were responsible for the October 19 crash, we will be held to account.

Senator **Sanford**. And we also stopped cigarette smoking in airplanes.

Senator **Graham**. We also stopped cigarette smoking on airplanes. Senator Sanford may want to comment further on that.

I think the question that all of us who essentially start looking at this from the perspective of free market individuals, are particularly sensitive to not wanting to restrain the natural creativity of the human mind, whether it's inventing machines or strategies to effectively use those machines. We are trying to understand what is the rationale for additional Government intrusion into what appears to be the natural order of the free market and man's innovation.

There was an issue raised by Mr. Regan which I'd like to explore, and that is the fact that this phenomenon of program trading and index futures seems to be leading to a shift in the mix of who owns America with a reduction of the individual and an increase in the institution, and that that shift may in turn affect the concepts, the expectations, or maybe the length of time in which economic consequences are being evaluated in the marketplace.

I wonder if you could comment as to if this phenomenon left to its own natural order does result in a significant redistribution of the investment community away from the individual and toward institutions? What kinds of consequences might we expect 5 or 10 years from now as a result of that?

INSTITUTIONAL OWNERSHIP

Mr. **Regan**. Let me take a swing at that, Senator. Of course, it's very hard to predict what's going to happen in the economy 5 and 10 years from now, but I would submit that to the extent that individuals don't have ownership of American corporations they will tend to leave the system. They won't tend to support the system as readily as they have in the past. I think we're all losers in that case because I think that has been one of the great things that has happened in America is that we have had this individual ownership of securities where people believed they're part of the economy. They don't think that there's a "they" or "them" some big guys up there that are running the whole thing and they're just a little cog and it doesn't matter.

I would much rather have individuals actively engaged in this. I admit that due to my past that there's prejudice here because of my association, not only with my former firm but also with Wall Street, and the rise of the individual as the buyer of American shares. But nonetheless, having said that, I would hate to see that figure go from whatever it is—30 million stockholders down to where it's much less than that, with the rise of institutions. I don't think that's healthy for capital formation and I don't believe it's healthy at all as far as believing in the American economy.

Mr. **Ball**. There are two other factors that may be pertinent. One, the individual shareholder tends to own stock for a significantly longer time than institutions and a whole lot longer than institutions who are just playing with the black box and a bunch of numbers. It seems to me that it's in the national interest to create a tapestry whereby loyalty and belief has some reward. You're not just buying little shares, little funny pieces of paper; you're actually betting on the ability, the zeal, the zest of a management in your home town or elsewhere. And that's something that is fundamentally good about an individual or many of the longer-time horizon institutions.

Second, the amount of money required to shift stock prices violently when that money is applied to the index futures is frighteningly small and, thus, not acting in concert, but the ability of the very few institutions who play with black boxes to totally destabilize stock prices is simply awesome. Again, that's something that is not in the national interest. It's not that these people mean to do anything wrong, but the liquidity in the marketplace and the ability of a highly leveraged index future to overwhelm the natural buyers and sellers is a mismatch that does not serve any of us well, in my estimation at least.

Mr. **Schwab**. I would submit one further thought, that the issue here before us is not whether or not this is for individual investors or against. I said 62 percent of American equities are owned by individuals, but the other balance happens to be owned by institutions for the benefit of individuals. So those people running those large funds are doing it for the benefit of beneficiaries or retirees and so forth, and the people I talk to, although I have not done a survey among these people—the majority of them, including 90 percent of the people—are very concerned about the same issues we're talking about in terms of these market mechanisms, front-running, short uptick rules being violated in spirit for sure. All those things they are very concerned about and they are very hopeful that this kind of legislation will be passed.

Senator **Riegle**. Thank you. Senator Gramm.

Senator **Gramm**. Mr. Chairman, let me first say I'm glad to see my old friend, Don Regan, again. I sense, Don, we have drifted apart on economic issues from those days when we worked together. I remember meeting you and you telling me you didn't know anything about politics, and I grabbed my wallet immediately.

Mr. **Regan**. I'm still against deficits, Senator.

Senator GRAMM. Well, that's reassuring. I was wondering, given your recent revelations, whether you were consulting astrologers on policy related to equities as I've listened to you today.

Mr. REGAN. Surprisingly, I'd add here, Senator, that there was a survey made just recently of people in Wall Street and stockholders, and 48 percent of them admitted that they used astrology at one time or another in the stock market.

Senator GRAMM. Well, I guess I'd have to say I want it clear that I'm on the side of program trading as compared to astrology.

I listened to you gentlemen talk about market manipulation and rigged markets and, of course, in the best tradition of American free enterprise you all have come to ask government to put down a competitor and to intervene.

I'd like to ask a couple of questions. If market manipulation and rigged markets and computer trading caused this tremendous drop in equity prices, how come prices didn't come back the next day? I think the argument would be a lot stronger that we've got innate volatility if the next day stock prices had shot up 550 points and the next day down 750 points. But the plain truth is that since that time, while a lot of good things have been happening in the American economy, there has been a slow, steady rise in equity values, with some volatility, but basically an uptick to regain about half of what was lost.

If it was manipulation, if it was rigged markets, if it was computer trading or program trading, how come the markets didn't come back? How come they didn't rig it going in the other direction? Do these people just like to see—are they rigging it to make prices go down?

Mr. BALL. Senator, if I could, I would disagree with the word "rigged" or "manipulated," for I do not think that anybody has attempted to act either individually or in concert to make prices go one way or the other. But that is the consequence, I believe, of portfolio insurance, of legging, and, on an intraday basis, over a few days of program trading itself. So I don't think that there's been anything pernicious done, that it's simply a combination of events not predicted by me, I must admit, or by others, that have created a situation that needs to be dealt with.

Senator GRAMM. Well, now let me just throw out a secondary question as we're going down the line. Did the use of index futures—do you want to give that whole process credit for a 500 point decline? Do you want to give them any credit for the 1,000 runup, or was that simply the functioning of great markets in New York?

Mr. BALL. That was unquestionably a period of time where euphoria bubbles were built into the market because of the same factors that caused it to drop. People don't complain as much when things are going up as down. The same conditions existed I think.

Mr. SCHWAB. I would submit, Senator, that in terms of the question of why didn't the market respond going right up, there was a tremendous panic and fear of the next downdraft. If it could go down 500 points in virtually a day, why couldn't it go down the next day another 500 points? People who we see have moved from equities, they've moved into very conservative cash positions, money market funds kept on rising very nicely and so on, so they are clearly fearful of the next leg of the next big downdraft.

As to the question about why didn't we say something when the market was rising, I for one and I'm sure many of my colleagues had no idea what was going on there in the CME in terms of the impact until the Brady Commission came out and disclosed all of these issues and all of the magnitudes of the changes going on in the index futures. We had no knowledge of it, to speak of.

Mr. **Regan**. As far as I'm concerned, Senator, I think you have to look at psychology for your answers as to why the market hasn't snapped back much faster. There was a complete sea change in psychology after October 19 as compared to 1 month or 2 months or 6 months prior to October 19. A burnt child dreads fire. Any type of petty saying you want to use I think applies here. The individual investor was absolutely frightened by that drop, not knowing what is going on in this economy. They're looking at a portfolio they thought had something going for them and all of a sudden they lose 20 percent or more of the value depending upon the individual security they held. They're not going to rush back in to buy. I don't care how much an economist would reassure them or the Fed would reassure them we're going to take care of things. They're going to stand by and see what this means, and that's why there hasn't been that run back.

As far as the upside of this market is concerned, in restrospect, we can now see, as Chuck has suggested, on the basis of an investigation that, yes, this did exacerbate the upside. We got to a price-earnings ratio on the Standard & Poors—what was it—27 times earnings, an unheard of figure for the U.S. economy, just ready for a fall. Now when that fall happened, it got another shock from program trading and I think that's what resulted in the 500 points.

Senator **Riegle**. Senator Sanford.

Senator **Sanford**. Thank you very much, Mr. Chairman.

I'd like to add my word of thanks to the three panel members. I especially welcome Mr. Ball with whom I've served on a board and had some peripheral affiliation with his company. I'm pleased to have you.

I think this panel, Mr. Chairman, has certainly been the most forceful of some very good panels that we've had and you've come here with strong suggestions.

There are so many questions I'd like to ask in such limited time that maybe we can submit some questions for further elaboration.

Let me just deal with two points if I have time. One is rather general and I would hope maybe each of you would comment on it.

The bill that is before us is the Proxmire bill that I assume each of you has agreed with or endorsed perhaps or at least recommended. It deals with a structural change, an organizational change, but it doesn't deal with all these stern actions that you are recommending, and how do we get at it? Initially, we were told to leave it alone and there would be others that would regulate it, that Congress couldn't get into the fine-tuning. So we have at least four areas where these changes might be affected. You've got the industry itself. The drawbacks there are that there's a lot of self-interest, there's a loss of profit. There are some large companies that might take action, as they did yesterday in suspending certain types of trading, but there are other aggressive firms that probably would not. In any event, it's a large industry.

Second, the self-regulating organizations seem to be concerned and at the same time somewhat fearful of a flight to overseas markets if they are too harsh.

Then we've got the regulators who, for whatever reasons—maybe they're not quite sure of how to go, as we're not—but in any event they have been dilatory of what we thought they would do.

Then you've got Congress and how much can Congress do, but our responsibility is to do whatever ought to be done so that we do not in the future have some kind of additional disaster.

I'd like your comments, with regard to congressional action, on just where the initiative now ought to be?

INDUSTRY SHOULD TAKE INITIATIVE

Mr. BALL. Senator, if I could, my feeling is strongly that the ball, which is a pun I usually don't use, is in the industry's court to take the initiative. Basically, a pox on our house if we don't do something that gets the thing out of stuck. In other words, there's got to be an industry initiative and then sweeping up our self-regulatory organizations as to standards of conduct, as to the things that we will and won't do. If we can put our house in order, maybe with some pushing from you, then I think it may be fair to turn then, but only after we've come to some degree of short-term agreement—again, if we can't, then we deserve whatever we get, which will not be pleasant—then we could turn to the regulatory agencies and to you if some legislation is needed to keep those perfidious factors who might not work in a consensual fashion with the rest of the industry and the regulatory bodies.

So I think probably in terms of action you should come last, acting if, and only if, the industry is unable to align things in a way that meet the national interest or if we don't I suppose doing something quite draconian.

Senator SANFORD. Well, last but more drastic, but what about this bill now? Would that get the industry's attention?

Mr. BALL. I think the bill is very helpful, but unless the industry does something itself, then the bill is a paliative and not a cure.

Senator SANFORD. But would the bill urge on the industry?

Mr. BALL. Yes, sir.

Mr. SCHWAB. I think the bill does a number of very fine things. It clearly gets the working party above the self-interest of the industry—all industry—the commodity industry, the options industry and the stock industry, which right now simply won't happen until something like this occurs.

I might suggest that you might put a sunset on the bill. It sets up the mechanism for coordination and maybe it should be a 2-year bill and then reviewed by Congress at that time would be my suggestion.

Mr. REGAN. Senator, before I got into government, while I was in government, and in life after government—and believe me, there is one—I have been opposed to government regulation. I think less regulation is the best regulation. But in this particular case, unless the industry adopts what Mr. Ball has just said and that is that they themselves act, then I think the Congress has to act. I'm a practical person. I am looking at the legislative calendar and time is waning. I'm not sure whether or not this Congress will have the time for such a bill. But, on the other hand, think of the consequences if between now and the next Congress and when you get around to passing a bill in the next Congress something again happens to the stock market as happened in October. And believe me, as the three of us have said, the forces are still there. Then people are going to ask why didn't the Congress act?

Now the final point I'd like to make on the bill itself, as a former Secretary of the Treasury, I am surprised that Treasury has not been brought into this. I think that Treasury, of all agencies of the executive branch of government, has an interest in the American economy and probably should have a seat at that table. I take that from the experience that I had as Chairman of the Depository Deregulation Commission, as Secretary of the Treasury. I think that Treasury was able to bring a point of view to that board and as a fifth member I think you should have somebody from the outside. I see no reason why there shouldn't be a representative of the public on such a commission, along with the three already suggested. I would add Treasury and a member of the public.

Senator **Sanford**. Thank you very much. My time has expired, Mr. Chairman.

Senator **Riegle**. We have another panel before us and I know there's great interest in these three witnesses. I'd like to quickly try to put to you to yes or no questions that I think it's fair to put to you and I think you can probably answer that way if you will.

In light of everything you've said today, one question I would pose is this. I gather that each of you feel that the market system, the way it's working today, is not really fair to the small investor and so I want to pose the question this way and ask you if you can give me a yes or no.

Do you think the market system today as it's working is really fair for the small investor, absent the changes you talk about?

Mr. **Regan**. No.

Mr. **Schwab**. Well, I think it's 99 percent fair. It's this abberant area that we're speaking to that I think is unfair.

Mr. **Ball**. No.

Senator **Riegle**. The second question I'd like to ask you, again based on—you've said a lot of things related to this already this morning. The clear sense I get from each of you is that you do think that capital formation process has been harmed and the capital investment process has been harmed by the things that we are discussing; and am I correct in inferring that that's your judgment?

Mr. **Regan**. That's the evidence so far for the first 7 months after October 19. There is much less capital being raised now than there was in the 7 months prior to October 19.

Mr. **Schwab**. I'd say an emphatic yes.

Mr. **Ball**. Yes, and if we get another panic or collapse, then it could go far beyond and be far worse than anything that we've seen even up to now.

Senator **Riegle**. I want to pose one other thing to you, Mr. Regan, and I want to refer to something that you indicated in the book that's just come out and it was interesting to read the review in the Washington Post this morning which said that that reviewer felt that you had produced an honest book and my view of you and my experience with you over the years is that your're an honest man and people can like or dislike what you may have to say, but you deal straight out and that's your reputation and that's your history.

And you said in that book that throughout your years at Treasury that you never had the occasion to meet one-on-one with the President on economic or financial matters. I was quite struck by that, the fact that that was so.

At the moment we've got a working group that's been named since the Brady Commission where we have one of the officials at the Treasury Department—not the Treasury Secretary himself, but Mr. Gould, who's heading up this working group presumably to try to cull through these same issues that we've been discussing here today, and in a sense, when I listen to the testimony of all of you, the scale of this problem and what's being done to try to make sense out of it and to respond and deal with it, on the one hand, one would like to assume that the President would be right involved in this and calling people in, people like yourself, people in the Government, taking charge, talking about it, asking probing questions and so forth.

If that's not going to happen, then I would feel somewhat better if the Treasury Secretary himself were heading such an effort. No disrespect to George Gould, but I say to myself, if this problem is of the level of seriousness and implication for economic future of the sort that we've been describing here, why isn't there more of a sense of urgency? Why aren't we seeing absolutely the top people in our Government, certainly the President qualifies in that respect, or his immediate designee, sort of taking and ramrodding these issues to some kind of a conclusion?

I'd like to particularly know your sense as to how we should perhaps try to make sense out of what's going on here on the administrative side in terms of the Brady Commission, the Brady Commission named by the administration, came back with a series of very specific recommendations and as you yourself point out, a lot of time has run and Nick Brady has now made a lot of subsequent comments because he is very anxious about the fact that there's been no specific administrative branch followup, and now we've got another study group headed by a person who is sort of down the line in the Treasury Department. I mean, what are we to make of this? Isn't this something that the top people in our executive branch ought to be working on with some very high priority?

Mr. REGAN. Senator, I have to duck that question. Obviously I haven't been in touch with this administration and since the book has come out obviously I'm not going to be in touch with this administration. So I can't answer your question.

Senator RIEGLE. Well, let me pose it a different way. I can appreciate that. The message that I'm getting from your testimony today—and you put it out with the varnish off as have your colleagues at the table—and that is that you convey a clear sense of urgency. You say this is a very serious problem. We need action now. Time is awasting. We're in jeopardy by not acting. It sounds to me like you feel that this ought to go right to the top of the list. Aren't you in effect saying that? Isn't that the message not just to us but to everybody with a major position of power and responsibility in our Government?

Mr. **Regan**. Well, what I'm suggesting is, is that as long as you leave these things out there, all the ingredients for a fire, if suddenly that fire breaks out, the responsibility is going to be shown to be here in Washington, not in Wall Street or LaSalle Street. So I would suggest that all of Washington has to realize that this problem is there and while there may be more titillating things within the beltway, certainly beyond the beltway this has to be a major issue.

Senator **Riegle**. We've received no legislative recommendations yet from the administration on this issue.

Senator **Gramm**. Mr. Chairman, if I might take a similar 5 minutes, I listened to Mr. Ball talk about "we" in the industry, that "we" need to work things out in dealing with these things. Are we counting our Midwestern country brothers in that "we"?

Mr. **Ball**. Categorically yes, Senator.

Senator **Gramm**. So you think they're going to work out an agreement to eliminate a substantial amount of their market?

Mr. **Ball**. It seems to me that the futures exchanges are ultimately there to serve their end use customers, that they're not there simply for the desire or pleasure of the membership themselves nor do they view themselves in that fashion. Hence, if it is overwhelmingly arguably in the national interest, the economic interest, or their self-interest, because their constituent clients would just as soon that a particular instrument not be traded, I think they can reach some degree of accommodation that would be perhaps noble, but noble is not a bad word and not unknown on the Merc or the CBT or other places.

Mr. **Regan**. I think there's some history to this, Senator. Again, I don't have exact dates or facts, but someone on your staff could look this up for you. I believe they stopped trading in potato futures in either the 1960's or 1970's when there was an actual scandal in the way that that market was being run. I think at the time of the salad oil scandal that they also stopped trading on soybean oil and a few of the other oils until they could sort that one out. So I think there's precedent for these markets to take the lead themselves—that is, their board of directors take the lead and say, "Hey, there is something wrong here. Let's shut down trading until we can get it straightened out, and then we'll come back again with the same or similar or somewhat different contract."

Senator **Gramm**. Would one of you define for me real quickly what you mean by program trading so I'm sure I know what it is you want banned? If you could do it in two sentences, or break it into two or three parts, it would be helpful.

DEFINITION OF PROGRAM TRADING

Mr. **Ball**. The simultaneous and near simultaneous sale—let me just stand to one side, Senator, for these—sale of a group of securities and the purchase of an index future which aggregates that same group of securities.

Senator **Gramm**. So that's your definition of program trading, that if you did one or the other, it would be all right using the computer to do it quickly? It's just doing both at the same time that's bad?

Mr. BALL. Yes. Senator, to be precise, since you're asking a relatively precise question, I believe it is the interaction of index-arbitrage and portfolio insurance that creates the basic, devastatingly destabilizing element.

Senator GRAMM. So if we did away with portfolio insurance, then that would eliminate the problem; is that right?

Mr. BALL. As a practical matter, I believe it would eliminate the real problem. There would be a perceptual cloud still lingering, but if there were no portfolio insurance or legging—the equivalent—then I think that the degree of excess volatility in the markets—the avalanching that I referred to—would be diminished dramatically.

Senator GRAMM. How would you do away with that other than by doing away with index futures?

Mr. BALL. How would you do away with portfolio insurance?

Senator GRAMM. Yes.

Mr. BALL. I don't know. I don't know how you could legislate, regulate or oversight that. I wish I did, because I would come forth with exactly that suggestion.

Mr. REGAN. There is a way to do it, which is on margins. If you consider that these are equivalents, that buying 1,000 index futures and simultaneously selling the underlying securities have an equal dollar value, they should have equal margin then. So if you're going to require on the purchase of securities 50 percent or 100 percent on short sales, why not the same thing on futures? If you're going to sell futures contracts without owning them and they are the equivalent of securities, why not a 100-percent margin? That would cure the problem.

Senator GRAMM. Thank you, Mr. Chairman.

Senator RIEGLE. Senator Wirth.

Senator WIRTH. I have a lot of very specific questions. One, if we were to curtail or ban stock index futures—and you started to touch on this a little bit, Mr. Ball—how do you answer the question that this would just move offshore and be a major industry offshore and we wouldn't have accomplished anything?

Mr. BALL. The question of losing the financial markets, and haveing them move from the United States elsewhere, is a very worrisome one, Senator. We do have regulatory or SRO authorities today that will properly handle the situation as it relates to domestic institutions in domestic or foreign markets. The more complex problem, then, is a foreign institution trading in a foreign instrument but one that is linked back to the U.S. markets. There, you would probably have to have a requirement that conversions in cash or kind be prohibited whether domestic or offshore to onshore and then you would have to rely on the honesty and the oversight of the firms who trade or who execute orders for clients to see that they don't circumvent that rule.

Senator WIRTH. But it's difficult to do.

Mr. BALL. It's difficult, but not impossible, Senator.

Senator WIRTH. Mr. Schwab.

Mr. SCHWAB. I'm not as fearful of this moving offshore at all. This is the major market in the world next to Japan and I think the New York Stock Exchange member firms providing the access to the commodity market simultaneously is going to be very difficult to do this offshore in any size.

Mr. **Regan**. I agree with that. I think that foreign firms will not engage in this by themselves if American firms are prevented from executing such orders.

Senator **Wirth**. The second question, the idea of margin has been brought up about changing the margin requirements. It's my understanding that a professional trader in New York operates with a 20-percent margin requirement approximately. Is that right?

MARGINS

Mr. **Regan**. You would have to ask these gentlemen. I'm no longer in the business.

Mr. **Ball**. The professional trader of a securities firm?

Senator **Wirth**. Yes.

Mr. **Regan**. 20 to 25 percent.

Senator **Wirth**. And the maximum that that professional securities trader has 5 days in which to settle his transaction, is that right?

Mr. **Ball**. Five business days, seven calendar days.

Senator **Wirth**. Now what's the difference between 20 percent requirement with a 5-day settlement time or a 7-day settlement time and the requirement that now exists, as I understand, in Chicago of a 15-percent margin and the requirement to settle that same day? It sounds to me like those are pretty much the same. What's the difference?

Mr. **Schwab**. Well, I would say one thing further. As far as my understanding, there's a whole group called the locals that have no margin requirements as long as when they initiate the transaction in a day and close it by the end of the day they have zero margin requirements. That's a substantial difference. There is a material difference between 15 percent margin and 20 or 25. I would say to you——

Senator **Wirth**. 15 percent if you have to settle that very day or 20 percent if you have to settle 5 days later.

Mr. **Schwab**. Well, it is relatively significant at those thin margins, but individual customers out there have 50 percent they have to deal with, so there's a tremendous difference in the competitive position.

Mr. **Ball**. Senator, further, the margin for hedgers—and these people doing index arbitrage would qualify in almost all cases as hedgers—was raised to only 10 percent.

Senator **Wirth**. It seems to me that as we talk about margin requirements, there are all kinds of margin requirements and it's not as if New York is sitting there with a 50-percent margin requirement set by the Fed and that there are tiny margin requirements in Chicago and that we're dealing with just two poles. I mean, there are a whole lot of different kinds of requirements for different kinds of individuals and before getting into the margin requirement business we ought to make sure we clearly understand that there are all of these differences. That's the point. Isn't that correct? And it's unfair to try to polarize this, isn't it?

Mr. **Regan**. Well, to the extent that an institution has a requirement in New York and the institution there—I'm not talking here about the individual house of Goldman Sachs or Morgan Stanley or somebody of that nature. I'm talking here about Wells Fargo or about a Morgan Guaranty Bank or Bankers Trust. Their margin requirements are certainly not that of a professional. They're an outsider for that purpose.

Senator **Riegle**. Would you yield just for a moment on that? I think that's a very important question and I think it's important that we really get down clearly and comprehend these cross connections between margins for different kinds of trading accounts and different kinds of players. I really think that is an important thing for us to understand and it's very hard to understand. I think you folks that are professionals in the business and have lived with it as part of your professional knowledge you understand it, but I think for those of us who are not and others who want to try to analyze the cross connection it's very difficult to do.

So I'm going to make the request that we, with your help and the help of others, that the committee in fact pin that down so that we understand it just as clearly as it can be defined in a fixed way.

Senator **Wirth**. We could ask the exchanges to come back and tell us that, the various Chicago and New York groups could probably do that pretty quickly. They must have all that as a matter of record right there anyway. You can figure that out, Mr. Chairman.

Senator **Riegle**. We're going to instruct the committee staff to get that information.

Senator **Wirth**. Let me ask another question that relates to some of the specifics that have come up in this. That is, the auction mechanism that exists in New York and the argument that's made that the New York auction mechanism or clearance mechanism is antiquated, it's very slow and not up to date compared to what it ought to be (1) and compared to Chicago (2). What's your reaction to that?

AUCTION SYSTEM

Mr. **Schwab**. Well, I would say the auction system on the New York Exchange works fairly well under regular kinds of days. Certainly it had some troubles on October 19, but as to the clearing, one of the major issues here about the unified clearing which comes forth in your bill is that some of the futures clear—not clear—they have to have margin requirements come up on an hourly basis, on options you settle the next day, and stocks you settle 5 days later. So for firms that are handling these things simultaneously, we had virtually almost a financial crisis on the 20th or actually through that next week and, thank goodness, the Federal Reserve stepped in voluntarily—they may have been given some push by somebody unknown—to help the system to force the banks to make sure that the broker-dealers had sufficient cash and credit to settle all those disjointed settlement days.

Senator **Wirth**. Is there resistance in the New York Stock Exchange from the people who have the ability to make markets on the floor and the specialists there? Is there resistance among the specialists to this kind of electronic upgrading?

Mr. **Ball**. There is some degree of resistance. I think there are probably two or three lessons, Senator, that we think should be learned. One is the auction and clearance processes have to be integrated amongst and between the exchanges, and on an online basis. If someone had actually marked to the market all of the specialist and other firms midday on October 20, I think you would have had a financial bankruptcy that would have teetered into the banks and probably pulled down a number of the banks. If you actually had to count up how many chips everybody had left, it might have been something that would have created an old-fashioned financial panic—closing of banks because major borrowers went bad.

The mechanisms used by the New York exchanges currently to clear and process trades are not as well automated as they need to be. That's something where improvement needs to be made.

Senator **Wirth**. If I might tie those two questions together, Mr. Chairman, with the question about the governance of these exchanges, it seems to me that if you look at the Chicago Exchange some of the arguments are made that they are governed by a number of people who have a stake in low margin requirements and it's unrealistic to expect them to increase them. On the New York Stock Exchange, a lot of members of the board of governors of the exchange are specialists who resist this kind of upgrade. Maybe that leads to the suggestion that maybe there ought to be a requirement that all of these exchanges have a majority of their governors who are outsiders. What kind of sense does that make?

BOARD OF GOVERNORS OF EXCHANGES

Mr. **Ball**. The New York Stock Exchange has a definite majority of its board of governors who are not specialists, who are not involved with the floor process.

The Chicago exchanges, to the best of my memory, do not have such a requirement.

Senator **Wirth**. Mr. Chairman, we're concerned about assuring the little guy is getting a break and preventing inside activity and inside advantages by those who are involved on the floors of all of these exchanges. Maybe what we ought to be looking at is a requirement that would suggest that more than 50 percent of the people on the governing boards of these exchanges be outsiders. The expressed purpose is making the kind of separation of self-service from public service that has been part of the theme of this discussion this morning. Does that make sense?

Mr. **Regan**. The trend has been that way. I remember when I was vice chairman of the stock exchange back in the 1970's, there we kept getting more and more public governors on and I would think that the public is well represented now in New York. I cannot answer for the Chicago exchanges.

Mr. **Schwab**. I would just simply say I would add to the movement to have some outside review of this. I think that's a good suggestion.

Senator **Wirth**. Finally, if there's a circuit breaker that says at 200 everything stops, why at 153 doesn't somebody decide, hey, it's going to go to 200 and I'm going to get out now, or 165 or whatever it may be.

Mr. REGAN. Well, I think that's like giving aspirin for a fever. It might help somewhat to bring the fever down but you've got to find out what's the underlying cause of the fever and deal with it, not just give aspirin.

Senator WIRTH. So you're saying that the circuit breaker is an aspirin and you've got to go a lot farther. I agree, but I just wanted to get your reactions to the circuit breaker idea which is one of those it seems to me that sounds good if you say it fast enough, but if you really look at it there might be some real problems to it.

Mr. SCHWAB. I would say from a public investor's point of view, the 250 point is very cold comfort. It happens to be twice the numbers we saw in the crash of 1929. I think we need to have circuit breakers and I've recommended that the circuit breakers first come in the futures area and only then, if there's a real calamity happening that maybe the exchange would close through workings with the administration and it has closed, usually with a snowstorm or a death of a President or something like that, to allow time for the dissemination of that very critical information.

Mr. BALL. I think that circuit breakers are valuable primarily as a public relations gesture—and a positive one, one that may help perceptions. But in terms of the reality of what they would do, the aspirin analogy that the Secretary used may be overstating their medical value.

Senator WIRTH. It seems to me we ought to be careful not to let public relations exceed prudence and looking at the markets as well and understanding the markets.

Mr. Chairman, thank you very much.

Senator RIEGLE. Mr. Ball, you just said something I thought was very important in response to Senator Wirth and that is, you said you thought, on the 20th, midday, if we had really been able to square all the accounts, that we might have been on the edge of a kind of financial bankruptcy, that the system, the financing system, might not have been able to hold together and either be paralyzed—those are my words—or shut down in some fashion. Is that a fair characterization of what I understood you to say to him?

Mr. BALL. Yes. I'm not positive that those circumstances existed, but we were a lot closer than anybody would have liked to think.

Senator RIEGLE. But that's your anxiety.

Mr. BALL. Yes.

Senator RIEGLE. Would that have your view, Mr. Regan? Looking back, did you feel that the liquidity problem and the capital sufficiency problem, when this thing was being hammered that way, was that close to the margin?

Mr. REGAN. As you read the Brady report, you are struck with that fact, that that could have existed. I don't think there's any empirical evidence there to actually indicate what had happened or might have happened. But, certainly, that's the implication in the Brady report.

Senator RIEGLE. You see, you've heard at least two points of view from this side of the table today. There are some on the committee that feel because sort of the surface operating data in the economy looks pretty good that really there's not much to worry about and then there is another point of view that says that if you've got inherent structural problems that threaten and you don't deal with them, even though you may have a fundamentally well running economy, you can have a situation where your system can break down for other reasons and in effect you can lose the good economy because the machinery stops working properly.

Sometimes it's hard to fit those two concepts together and they really create a difference of opinion around here as to whether anything ought to be done. It seems to me that if in fact it's plausible to conclude that we were having a liquidity, capital insufficiency problem on the 20th that could be almost like a sort of a capital—we've been using medical analogies—like a heart attack that sort of takes and hits the system with such strength that the system can't function, that the system kind of freezes in place, then you could get a whole set of consequences after that of the sort that nobody even wants to imagine. But I draw that inference from what you've said, Mr. Ball, that there was that kind of risk introduced at that point and that's something I gather you're saying you want us to move away from, you want us to get out of the position of testing the outer limits of just the credit strength and the capital strength of this system at a time like that. Am I right in drawing that conclusion?

Mr. **Ball**. The system survived, I think, largely because there had been 6 and 7 years of very high profitability through the financial services business. But if first one and then a number of major specialist firms, for example, were to fail, and then some smaller firms that had counterparty dealings with the specialist failed, and then borrowings to major banks became unsecured and went bad, you could get a domino effect that could ripple all the way through, almost like a neutron bomb—everything would be standing but all the people would be killed. I don't thing we really want to test the brink of that at all.

Senator **Riegle**. If you'll indulge me one more minute here. Secretary Regan, when you were running Merrill Lynch, you had an excellent reputation for being very tough on the enforcement of securities laws. That was just your standard and you were known for that.

Do we need stronger enforcement of the securities laws now, do you think?

Mr. **Regan**. Yes. In a radio spot the other day, I characterized this that our watchdog is becoming a lap dog. I think that the watchdog committees, not just the SEC but the CFTC also, ought to be much more strict than they are.

Senator **Riegle**. And in terms of tightening and clarifying the law on insider trading, several of us have been at work here to try to get that done. Is that important, in your view?

Mr. **Regan**. Oh, very important and very confused. We not only have new initiatives in financial instruments over the last few years but we've had a lot of new initiatives in insider trading that may be still legal, but maybe shouldn't be allowed to exist. I think that whole subject needs revisiting.

Senator **Riegle**. Gentlemen, let me thank all of you. You've been very patient and very forthcoming and we appreciate your testimony. Let me thank you and we'll call our next panel to the table. Mr. Murray, Mr. Reilly, and Mr. Needham.

Gentlemen, we welcome you before the committee today and we appreciate your patience. We have had a long and very interesting morning and you have been able to hear as you've been present.

We will start with you, Mr. Murray. You're the chairman and the CEO of Brean Murray, Foster Securities, Inc.

STATEMENT OF A. BREAN MURRAY, CHAIRMAN AND CEO, BREAN MURRAY, FOSTER SECURITIES, INC.

Mr. MURRAY. Thank you, Mr. Chairman, I appreciate being invited here to express my points of view.

[The complete prepared statement of Mr. Murray follows:]

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Laying Off Risk—But on Whom?

That's the Billion-Dollar Question About Portfolio Insurance

By JOHN W. SCHULZ

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TORRENTS of verbiage and tons of paper were dumped on investors when this month's Triple Witching Week threw the stock market for one of the deepest and fastest losses in modern annals. Most investors survived, some speculators went broke. No one seemed to ask how many speculators and investors might go under next time, and the time after that—every three months or perhaps even more often—and how many we can afford to lose, like so much cannon fodder, in the hedging game. The casualties are coming despite something called "portfolio insurance," which raises further interesting questions, notably: What happens to those who assume the risk from the insured?

By now, active investors surely have a working idea of the game's mechanism. It came into being in 1982, when the Chicago commodity exchanges began trading in futures contracts and options geared to prominent stock price indices, chiefly Standard & Poor's 500 (traders were dealing in Treasury-bond futures as long ago as 1977). The game became increasingly respectable as institutional investors gained an understanding of what certain academics had been demonstrating with mathematical formulas—namely, that futures and options could be used to hedge systematically against stock market risk.

What's more, a "basket" of stocks that replicates, say, the S&P 500 can be bought, and, at the same time, a futures contract on the S&P 500 sold, at a sufficiently higher price than the basket's cost; it thus becomes possible to earn a risk-free return that exceeds the yield from a three-month Treasury bill (also risk-free). Computers now can figure it out in a flash. This sort of arbitrage is the prototype of all the "program trading" that has been making financial headlines, on and off, in recent months.

To a man, the professors have hailed this innovation as a boon because it enables investors—mainly the elephantine institutional kind—to lay off risk on a broad scale. Major brokerage firms embraced the concept with great delight since it paid off handsomely for commission-paying clients as well as their own trading accounts. But program trading of this sort did not really begin to blossom into persistent frequency until the autumn of 1985 when investors began to sense that a new bull move was in the making.

Coming often in rapid-fire sequence and sometimes with astounding violence, this new market force unsettled many other market participants, especially those who like to make their investment decisions deliberately and to maintain some price discipline in their transactions. But as long as stock prices were rising, no one seemed overly upset. The academics—and futures exchanges—insist that program trading does not increase stock price volatility over the longer term, citing one professor's study to support the assertion. They concede, on the other hand, that in the presence of program trading, stock prices tend to move from one general level of valuation to another faster than they would in its absence.

The professors and their disciples avoid asking, at least in public, about the impact of their risk-avoiding programs on the risk takers. Perhaps they figure no one need shed tears for money-losing risk-takers, whether crapshooters or sophisticated in-and-out traders. But it may not yet be widely appreciated that one risk-taking group operates in a zero-sum game; the dollars one player in the futures markets wins, another player loses. What's now called the "cash market," where stocks and U.S. government paper are traded for prompt delivery and full payment, is not a zero-sum game; one investor's gain is not another's loss.

In the futures markets, risk is a distinctly quantifiable element called margin. Relative to the futures contract's face value, margins traditionally have been thin. Traders' accounts are marked to the market nightly, and additional margin, if needed, must be deposited the following day, failing which an account is sold out.

If the account, likely as not, still owes money to the carrying broker, the trader has to make up the deficit. If he fails to do so, the loss is the broker's. If the broker's capital falls short of such losses, the futures exchange's clearing house may have to take the hit, which then must be covered, in effect, by the exchange's other members (which nowadays include all of the biggest New York Stock Exchange member firms or their subsidiaries). The winners in this zero-sum game do not have to make up for the losers' red ink that may wind up in exchange members' capital accounts.

You begin to see how risk-

John W. Schulz is a managing director of Brean Murray, Foster Securities Inc., a member of the New York Stock Exchange.

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takers' mounting losses in a fast-moving, one-way market could threaten to destabilize a financial community that may be well capitalized but operates with a geometrically expanding volume of transactions. The threat was close to becoming disaster not so many years ago in the Hunts' silver crisis; only prompt intervention by the top powers-that-be averted it. Today's world of futures trading is far, far larger than it was then.

The numbers are staggering. The day before the stock market began to tank on Sept. 11, stock-index futures contracts outstanding—the "open interest"—numbered more than 143,000, involving aggregate stock-market values of nearly $16 billion, with some 80% of that related to the S&P 500. Trading volume for Sept. 10 was reported at just under 127,000 contracts, which means almost 90% of the total open interest might have changed hands, representing some $14 billion in contract face values, or more than twice the cash value of stocks traded that day on the Big Board. (On some days, trading volume in index futures exceeds the open interest.)

A large, though not overwhelming, share of the open interest is normally hedged by offsetting positions in the futures markets themselves. Thus, for example, according to data released by the Commodity Futures Trading Commission for Aug. 29, 1986, just over half of all open contracts on the S&P 500 was held by "large hedgers," leaving a very substantial minority accounted for mainly by "small traders" and, to a lesser extent, by "large speculators."

It may be quite unknowable, on the other hand, how much of the traders' and speculators' open-interest share is at any time hedged by offsetting positions in the cash markets. As a pure guess, perhaps far off the mark, say that 10%, or $1.6 billion, of the open interest was unhedged—totally "naked"—when stock prices went into a two-day free-fall that chopped 6.6% off the S&P 500. Because speculative futures contracts are often carried on no more than 5% margin, it may be fair to assume that something close to $100 million of risk takers' cash went irretrievably down the drain on those two days.

In today's world, that's probably nowhere near fatal for the overall financial system. Even so, there were tales in the Street of not a few busted futures traders—smaller ones, presumably—the risk avoiders' unlamented opposite numbers. But the big stock-index futures market is not alone; the market for Treasury-bond futures is even larger, with a $17 billion open interest as of Sept. 11. Considering that bond prices, too, collapsed, risk takers' overall losses could have run well into the hundreds of millions of dollars. Still not the biggest of deals, nowadays.

But this may be only the beginning. The professors, some of whom have taken lucrative positions with major NYSE member firms, have come up with a new hedging technique, the aforementioned portfolio insurance. This approach has in recent months been marketed aggressively to pension-fund sponsors and other big institutional investors as a way to hedge against significant declines in the overall level of common-stock prices. The merchandising of this concept is proceeding and expanding apace. Money managers are being inundated by invitations to high-priced seminars that will explain every wrinkle of the game. And word on the Street is that the promotions are spreading overseas.

The basic idea of portfolio insurance demands that the holder of a widely diversified stock portfolio, one that closely resembles the composition of the S&P 500, for example, begins to sell S&P 500 futures contracts when the index drops by a specified percentage—3% is a frequently suggested trigger—and continues doing so if prices keep declining until the portfolio's market value reaches a level below which further shrinkage becomes unacceptable to its manager or sponsor. Below that level, profits accruing to the futures contracts sold earlier will compensate for additional unrealized losses in the portfolio itself. To the extent that a portfolio is thus hedged, no sales of actual shares in the cash market are needed.

As any close watcher of the tape will agree, and as the insurance promoters will probably deny, portfolio insurance played a noticeable role in accelerating and extending the stock market's mini-crash on Sept. 11-12. The reason, to repeat, is that portfolio insurance calls for selling index futures contracts when stock prices have already fallen, which almost certainly means that the futures are sold at a discount from the index itself. Most of the futures will be sold to hedgers who, in turn, instantly sell baskets of stock (designed to replicate the index) in the cash market so as to lock in above-average riskless rates of return, no matter what the level of stock prices. In other words, when portfolio-insurance sales of futures are made at discounts, they provoke program stock selling by arbitrageurs into a falling market—a potentially endless process in theory only, one hopes. Risk-takers who buy the index futures without hedging can get killed in this game; unhedged passive investors are apt to be unenthusiastic.

What portfolio insurance thus does, very efficiently, is substitute aggressive sellers of stocks in huge quantities—namely, arbitrageurs—for others who ordinarily might sell more slowly and discriminately and now may need to sell no stocks at all—namely, "insured" institutional investors. According to some recent estimates, the technique has been already sold to portfolios with market values totalling $20 billion-$30 billion. Considering that public and private pension funds these days hold securities worth close to $1.5 trillion and that mutual funds hold some $500 billion more—much of those portfolios already structured to resemble the major stock indexes—a vast field beckons. And, as already noted, portfolio insurance salesmen are out there in growing force. Meanwhile, the practical limits to proliferation of the technique remain unexplored; they may not be met until liquidity in the futures and in the cash markets becomes hopelessly inadequate, when all trading must come to an abrupt halt.

There is a relatively bright side to portfolio-insurance insofar as it is marketed to include "dynamic hedging." This aspect of it calls for the insured, having sold index-futures contracts against a stock portfolio, to buy these contracts back when the stock-price index rises more than a specified percentage. In a rising market, index futures tend to sell at premiums above the index itself, which permits program-trading arbitrageurs to sell the futures contracts and, simultaneously, buy the basket of underlying stocks (also in order to earn an attractive riskless rate of return). In that situation, the overall stock price level can rise as swiftly and relentlessly as it did in the autumn and again in the late winter of 1985-86.

But it is in falling markets that the spread of portfolio insurance may pose a significant risk that cannot be laid off except perhaps on the entire financial structure. The academics' contention that arbitrage transactions involving financial futures and options merely move the general price level of common stocks to where it would go anyway, only faster, is plausible enough in a rising market. But can you rely on it when the program traders and insurers gang up on a slipping stock market?

The key threat in falling financial markets is velocity, the waterfall effect that gives the markets no time to stabilize. All too clearly, the threat looms larger as a result of the hedging formulas and portfolio insurance peddled by the academics and automated by computer arrays at major brokerage firms and banks. The not-so-little collapse in stock and index futures prices on Sept. 11 and 12 may have been only a bland foretaste of something sharper down the road.

That time, just a few crapshooters got thrown out of the game and have to go back to doing honest work. Next time, a lot more of them, plus perhaps a few million people—non-institutional bystanders who still own the bulk of marketable U.S. common stocks directly—may very abruptly find they took much more of the market risk than they bargained for and which the professors managed to lay off on them. If that's where we are headed, the academics and their disciples may find they have brainstormed themselves plumb out of business. No one will want to take that kind of risk—in the futures markets or in the cash markets, not for equities nor, perhaps, even for Treasury bonds. ■

Senator RIEGLE. Thank you, Mr. Murray.

Mr. Reilly.

STATEMENT OF MICHAEL J. REILLY, VICE PRESIDENT, INVESTOR RELATIONS, REUTERS, NEW YORK, NY

Mr. REILLY. Thank you, Mr. Chairman.

I do have more extensive testimony which was offered and I'd like entered in the record.

Senator RIEGLE. We'll make it a part of the record.

Mr. REILLY. My name is Michael Reilly. I am vice president for Investor Relations at Reuters North America, Inc. That's a Delaware company with its main offices in New York City. We have 34 offices around the United States and Canada.

Reuters is a leading world news and information organization. I know that the committee has been hoping to find some solutions to the issues at hand from the information industry as to what might be done in the U.S. equities market and I have two points in response.

There are many aspects of supervision, surveillance, and regulation and there are experts in the markets and those experts in those markets can advise on these. That's not our expertise in the information industry. We are experts in information flow.

On that score, we are able and willing to do what you and/or the markets say is needed—give us the information, whatever it is that you and the industry and the regulators decide is necessary for the investors or for the regulators and we can make it available in a timely fashion and in a reliable fashion.

Reuters is uniquely situated in the information industry to observe markets and their interaction around the globe. We have about 150,000 video terminals which are providing price information, news, and historical data to participants in equities commodities and money markets. Our principal market being in foreign exchange and in money.

I know you've heard a lot about program trading today. I do want to make it quite clear that Reuters is an information provider and disseminator. We do not do any program trading.

I'll speak a little bit more about Reuters and again call your attention to the more extensive testimony in the record which has more detail on the company's activities.

I'd like to express our deep appreciation for being here and commend the initiative of Senator Proxmire and other Members of the Senate with the introduction of S. 2256, the Intermarket Coordination Act of 1988. In particular and on behalf of the Information Industry Association, of which Reuters is a member, I want to make a comment on the information aspect of that proposed legislation.

S. 2256 envisions establishment of "information systems adequate for market surveillance and enforcement needs to include at a minimum information on the trade, time of the trade, and the name of the ultimate consumer in every major segment."

The information industry would like to see this spelled out in greater detail. Possibly it should be broadened to require increased access to financial information systems which are in and among or between the various exchanges so as to increase investor understanding and participation ultimately in the market.

There is some historical precedent for this being valuable. Positive results from a similar initiative as a result of the 1975 Securities Acts Amendments led in part to a period of extraordinary participation in equity markets. The addition of a composite quotes ticker, composite screen displays bringing quotations for money markets to a single display and the intermarket trading system itself which allows easier flow of orders between markets were all the result of 1975 legislation and it can be said that they helped in part to broaden stock market interest.

We have no doubt more information about trades, trading conditions and pent up demand will help stimulate investor confidence. Precisely how these might be implemented will depend very much on the needs of the market participants.

Reuters and the industry take the position that we can and will assist with whatever is required. We stand ready to do so now as legislators and market participants discuss the options available.

FOREIGN EXCHANGE MARKET

Our experience tells us that access to information has led to greater participation in the markets. Let me briefly paint a picture of our experience in the foreign exhange market which is the biggest one Reuters operates in and in fact it's the largest one in the world with $250 billion a day being traded.

Senator **RIEGLE**. Let me ask you to do this if I may. Because of the time pressures that we are under with activities that are going on on the floor, I'd like to ask you to try to finish your summary in about 2 or 3 minutes so we can accommodate Mr. Needham as well.

Mr. **REILLY**. Fine. I'd be happy to do that. Let me say briefly then that in the foreign exchange market Reuters was instrumental in bringing a computerized system to what was then a telephone and telex market. This resulted in improved activity in the marketplace. Surveys showed at the time that the volume rose rather dramatically as a few years went by with the use of this new kind of service.

In 1981, about 7 years after we introduced the first information service, we then provided a dealing service which gave traders the opportunity to actually be in touch to conclude a deal. Again, volume continued to rise very dramatically. We can't be empirically sure that the addition of information and the speedup of the flow of information contributed to more robustness in the market, but we think it did. Indeed, many bankers around the world tell us that that has been the case. So again, I stress that more information seems to help in providing a robust marketplace and the industry is in a very good position to provide that access.

I think I want to emphasize one thing. That is that the role of the information industry is to take information from a point where it begins and get it to the end user—in this case, the individual investor as well as professional investors. The originating point could be our news corps of journalists around the world or, the exchanges, 137 in fact in our network. So, information flows from that point to the end user and the industry has the ability to handle whatever information you feel should be moving through that system.

The other point I wanted to make here had to do with globalization and what's happening in global markets. There was a request from the committee staff that we comment on that. Among the distinguished directors of Reuters is Walter Wriston, a former chairman and chief executive officer to Citicorp, who some years ago identified information as the new international standard. I think we've all heard that this standard has really come home to Americans now in a big way. I don't think that was the case a few years ago unless they were in the international environment. We now have portfolio managers who never looked at a foreign stock before looking very carefully at a foreign stock. The information flows throughout the world, a system that has grown with the flow of information, and the information industry is prepared to stay in that position. We can offer to the regulators, to the participants in the market a very strong and capable ability to move information between the participants and Reuters, with 130 years in the information business, stands ready to assist in any way we can.

Thank you very much.

[The complete prepared statement of Mr. Reilly follows:]

United States Senate
Committee on Banking, Housing, and
Urban Affairs
Washington, DC 20510-6075

May 11, 1988
10:00 A. M.

Testimony by:

A. Brean Murray

THE CASE AGAINST STOCK INDEX FUTURES (PROGRAM TRADING)

Mr. Chairman, I commend you for calling this important hearing, which deals with some of the most disturbing and dangerous trends that I have seen in my 25 years in the business. The issues at hand affect the vitality of our financial markets; the competitiveness of American companies in World markets and the long-term economic interests of all Americans, not just investors. I appreciate the opportunity to share my views.

First, let me say that I came to America from Dublin, Ireland in 1950, at the age of thirteen, attended school in the Bronx, served 3 years in the U. S. Army 1954-1957, (Paratrooper, 82nd Airborne Division) and graduated from Villanova University in 1961. As an immigrant, and now, I believed America offered me tremendous opportunity, fairness and freedom. It was this strong belief that has guided me throughout my career and made it possible for me to attain my present accomplishments.

In my 25 years in the securities industry, my experiences have included management, sales, research, investment banking and venture capital. In particular, I would like to emphasize my working with smaller companies, often in the area of high technology and in the early phases of their life. In addition to benefitting financially, I have received great joy from knowing that I played a key role in bringing these companies into being, watching them grow, seeing them provide new jobs and unique products and services. This has resulted in the creation of thousands of new jobs. For example, I raised $2 million in 1969 to finance Shared Medical Systems which, at the time, had 3 employees. Today, Shared Medical Systems has 4,500 employees and has a significant impact on the Philadelphia economy. Another example is my own firm, Brean Murray, Foster Securities Inc., which I started in 1973 with 2 employees and $50,000. Today, we have about 100 employees, manage about $600 million, and every year finance -- very carefully -- a few budding companies. I serve on the Board of Directors of several such companies.

As you have pointed out, Mr. Chairman, and the statistics prove, these companies are the backbone of the economy, and in total are responsible for the most job creation. And it would not have been possible to create and finance these companies without a widespread confidence in our securities market. All the parties involved knew the opportunity and also the risk; this was understood. Subsequently, through good and bad markets, this understanding and the confidence in the essential fairness of the marketplace by both professionals and the public essentially remained intact.

A new and exceedingly disturbing phenomenon was introduced into our securities markets early in the decade; the linkage between investing and wagering. And that linkage, represented by stock index futures, in my view, demeans both the stock and commodity markets.

Our financial markets, whether they be the stock markets "equity markets", or the commodity markets, are truly a natural resource. These two markets are different and distinct, and should not be connected.

A stock certificate represents ownership in a business; a bond represents indebtedness of that business. In either case, the capital invested has found its way to the company involved. Without a confident primary market, it gets very difficult to raise capital, and without capital it is nearly impossible to create new jobs, new products, new technologies and enhance the well-being of all Americans.

Similarly, the commodity futures markets allow speculators to assume price risks so that farmers, oil producers, manufacturers and wholesalers are able to concentrate on their daily business, somewhat shielded from at least short-term price pressures. This process has social and economic value.

In many states, there is officially sponsored wagering through government set-ups like off-track betting. At least some of the proceeds help a worthy cause, such as education. I am not against wagering, but let's keep it out of the financial markets. Wagering belongs in the casinos and gaming parlors.

Capital committed to program trading does not find its way to the companies involved; indeed it very likely siphons off capital that otherwise would do so. It also, in my view, fosters a climate of wagering rather than investing, betting on the action of stock prices that is unrelated to any true economic or financial event. If we are to maintain and improve our competitive edge in world markets, and rebuild this country and its infrastructure, we must be an investor nation. If the market is to be overwhelmed by the short-term objective of program trading, which is strictly focused on price movements, there is little opportunity to accommodate true investors who are interested in the fundamentals of the companies of these underlying securities. The loss of these investors is contrary to development of capital formation.

It is my belief that index futures foster wagering rather than investing and produce the opportunity and climate for mass manipulation of the equity markets. These instruments create extraordinary artificial supply or demand for equities, and as a result, produce usual volatility, within the marketplace. This is a practice that our firm has been concerned about for the last 2 years, long before the crash of October 19, 1987. I personally appealed to the Chairman of the N.Y. and American Stock Exchanges, to express our concern about program trading. My colleague and partner, John Schulz, also a well-know financial writer and one with fifty years of market experience, warned about program trading in a September 26, 1986 Barron's article entitled: Laying Off Risk - But on Whom? (see attached).

The well-known financial writer, Andrew Tobias anticipated a crisis, too, more than a year ago. In his book, The Only Other Financial Guide You'll Ever Need, Tobias warned about "a vicious circle of program trading and portfolio insurance where one feeds upon the other, and around and around, until two 24-year-olds at Goldman Sachs and Salomon Brothers have bitten 500 points out of the Dow in a day. That could cause some loss of confidence."

The excess of program trading helped propel equity markets to dizzy heights last summer, and it contributed to the October crash, when $1 trillion of market value was lost in a week.

I have been dealing with investors for twenty-five years, and I have never seen them so shaken as today. Not because some of them have lost money - they mostly are well aware and quite accepting of the risks - but because they do not believe that the system is functioning properly or fairly.

They believe that it is controlled and manipulated by a few who care not about investors, not about companies, or their financial results and not about employees, but only about their objective of establishing and locking in a financial relationship between a stock index future and a so-called basket of stocks.

They don't care if they drive the market down 508 points or 2,700 points. Nor do they care who it affects. It was reported that on that horrible day of October 19th they were cheering and gloating about their good fortune.

Despite the crash, program trading continues because big investors want to pass on risks to small investors. The amount of money bet on index futures dwarfs the amount invested in New York Stock Exchange securities. So we continue to be whipped by 100 point swings. On January 8th, for instance, the market plunged 140 points. This happened in a very brief period of time. **Did anything change concerning the fundamental trends of the economy or the companies that make up the DJ Industrial average during that period of time**?

In my view, this climate is a major factor making mass manipulation of markets more likely than it has ever been. Although legal, it is predatory, unethical, unwise and has no economic or social value. What can be done? The simplest would be to ban all future index options. But, perhaps this is not realistic. At the very least;

1) There should be substantially higher margin requirements such as a minimum of 50% for all future derivative instruments.

2) Any sales of securities, futures or short sales related to these instruments must be done on a uptick rule; no exceptions, including member firms.

3) Impose modest position limits in futures owned by any one or associated party.

4) Consideration as to notifying the public when there is an imbalance in purchase or in sale orders in given securities as a result of these programs. The participants in such programs should be charged with the responsibility of not causing a disorderly market. Substantial fines should be imposed on those found in violation.

5) All public corporations who participate in these programs for their pension accounts should have to disclose this to their stockholders and employees. A list of all of these participants should be made public.

As to the Senate Bill S 2256, I support the principal of intermarket coordination and regulation, in particular I endorse that the Federal Reserve should have the authority to establish all margin requirement in all markets.

My reservation about the bill is that it may legitimize the practice of program trading since the Commodity Futures Trading Commission has a vested economic interest which is at odds with developing investor confidence in the equity markets.

Mr. Chairman, if we don't move quickly to protect our equity markets from the manipulation of program trading and all the instability it brings to our markets, I fear that America will loose one of its great resources, and that we shall permanently loose our competitive edge in world markets.

Thank you.

A. Brean Murray

Senator **Riegle**. Thank you, Mr. Reilly.

Mr. Needham.

STATEMENT OF JAMES J. NEEDHAM, FORMER COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION

Mr. **Needham**. Thank you, Mr. Chairman. With your permission, I would like to insert my entire statement into the record.

Senator **Riegle**. We will make it a part of the record.

Mr. **Needham**. I would just make one or two brief comments.

I am generally supportive of the legislation. I feel that legislation is required. I don't think you should sit and wait for someone else to do this job. History does not support that approach. I could go through it as I recall it as my capacity as a former Commissioner of the SEC and chairman of the New York Stock Exchange.

I think that where I do part company with the committee is that I favor functional regulation. It seems to me that what is trying to be accomplished through the creation of an interagency body or a superbody as suggested in the Brady report can be addressed more simply by revisiting the 1982 act and expand the definition of a security to include all these derivative products. That would lodge in one place all the responsibilities for the securities industry at the SEC without interrupting the normal day-to-day operations of the Chicago Exchanges and the other work of the CFTC. It seems to me it's sensible, it's easy, it's practical, and it puts it where it belongs, in an agency with the expertise of the problem.

There's just one other issue I do want to address Mr. Chairman. It's a question you raised. I think it would be a sad day here in the Senate of the United States to leave the record stand the way it is.

You asked the rather simple question and I was quite surprised. The question was, as I recall it, are the markets today fair? Am I correct? Isn't that what you asked?

Senator **Riegle**. I think that's an accurate summary of the way I was trying to pose the question.

Mr. **Needham**. I was shocked to hear——

Senator **Riegle**. Fair to the small investor I think was really the point.

Mr. **Needham**. Well, it isn't a question of whether you're fair to a small investor or to a large investor or any investor. You're supposed to be fair to all investors. If you aren't fair to all investors, then of course we do have a problem.

So I want to say to you that I was shocked that two of the three participants said they weren't. I submit for your consideration that they were in total error.

Thank you, Mr. Chairman.

Senator **Riegle**. Well, going back to that, and that was probably an hour and a half ago, the third respondent gave an answer that, had we had more time, I would have liked to have pursued because he in effect said they were fair most of the time but not all of the time. I think he used the 99 and 1 percent division. Of course, then if you just take that out, then the question is, if you're an individual investor, are you part of the 99 or part of the 1? And if you're out there thinking about becoming an investor and you're looking at a situation where you think there are times when the system may not be fair to you, does that dissuade you from coming in?

I didn't view his answer either as one that would necessarily give me a great sense of relief and confidence.

Mr. **Needham**. I think the small investor is adequately protected in the market. I think only because he's an informed person. He knows what's going on. He doesn't need the heads of major brokerage firms or chairmen of exchanges or former chairmen of exchanges to explain that to him. The flight to safety is not connected totally with or exclusively with the break on October 19. There are other reasons for that and I don't want to go into those unless you choose that we should.

My point simply is the issue that we have to address and it's in my testimony, we simply have to define what we mean by fair and orderly markets. It could be that our expectations of the past requires some type of revision. I have covered that in my testimony and I'm sure the committee will address that issue itself.

[The complete prepared statement of Mr. Needham follows:]

STATEMENT BY

MICHAEL J. REILLY

VICE PRESIDENT, INVESTOR RELATIONS, REUTERS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

MAY 11, 1988

Good morning. My name is Michael Reilly. I am vice president for Investor Relations at Reuters North America, Inc., a Delaware company with its main offices in New York City and which has 34 offices across the U.S. and Canada.

As part of the Reuter Group worldwide, we are uniquely situated in the information industry to observe markets in their interaction worldwide. Around the globe, Reuters has about 150,000 video terminals providing price information, news and historical data to participants in equities, commodity and money markets -- our principal market being in foreign exchange and money.

I'll speak more about Reuters and world markets later in my testimony, and I would point out that extensive information on the company is available in the written submissions.

S. 2256

I would like to express the deep appreciation of Reuters and its senior management for the opportunity to address the Committee. In particular, we commend the initiative of Senator Proxmire and other Members of the Senate in the introduction of S. 2256, the "Intermarket Coordination Act of 1988."

In particular, and on behalf of the Information Industry Association, of which Reuters is a member, I want to make a comment on the information aspects of the proposed legislation.

S. 2256 envisions establishment of "...information systems adequate for market surveillance and enforcement needs to include, at a minimum, information on the trade, time of the trade and the name of the ultimate consumer in every major segment..." The Information Industry would like to see this spelled out in greater detail and broadened to require increased access to financial information systems in and among the various exchanges so as to increase investor participation.

Positive results from a similar initiative as a result of the 1975 Securities Acts Amendments led in part to a period of extraordinary participation in equity markets through the fall of last year. The addition of a composite quotes ticker, composite screen displays bringing quotations from many markets to a single display and the Intermarket Trading System, which allows easier flow of orders between U.S. markets, were all the result of the 1975 legislation and helped broaden stock markets interest.

We have no doubt more information about trades, trading conditions and pent-up demand will stimulate investor confidence. Precisely how these might be implemented will depend on the needs of the market participants. Reuters has always taken the position that we can and will assist with whatever is required. We stand ready to do so now as legislators and market participants mull the options.

PROVIDING MARKET NEEDS

To breathe some life into what I've just said, let me draw a picture of Reuters' experience in the foreign exchange market -- the biggest market in the world where an estimated 250 billion dollars worth of currencies and currency-related products are traded every day.

In 1973, after years of planning and discussion, the market received something it sought from Reuters -- a system to allow traders to show their rates to one another, bypassing multiple phone calls to get quotes. The market was uneasy with using telephones as exchange rates began to change more rapidly after the breakdown of the Bretton Woods system. Reuters then built the system to help. It was designed to support 250 screens.

Today, the Reuter Monitor network has around 150,000 screen terminals, including those of another innovation the market sought.

This one was requested as the eighties were approaching. Dealers felt they should have a way of dispensing with the telephones and telex and to use the now familiar screen and keyboard on their desks to communicate with each other. In response, we introduced the Reuter Dealing Service. This is a conversational facility allowing a trader to contact any other trader directly, by name, and open a conversation using the terminal keyboard to communicate.

They can agree on terms of a deal and confirm with a single keystroke, then move on to the next caller.

What did these improvements to information flow do for the foreign exchange market? We can't be sure it was all the doing of Reuters by providing good communications and technology, but we think -- and many customers in banks around the world have told us -- that was the case: participation in the market rose sharply.

The Group of 30 surveyed the foreign exchange markets in 1979 and estimated daily volume was at 75 billion dollars a day -- perhaps three times what it was when the Reuter Monitor started up. Five years later, after we introduced the dealing facility (1981), the group did another survey and found volume to have doubled to 150 billion dollars a day.

And now, with thousands upon thousands of pages of data in our foreign exchange database and hundreds of the world's banks using our network to assist trading, the daily transactions are estimated to exceed 250 billion dollars. In each case -- the creation of the Reuter Monitor network as an advertising medium for foreign exchange rates and, subsequently, other information, and the development of the Reuter Monitor Dealing network -- the market had entered a stage of preparing itself for innovation designed to improve the efficiency of the market and meet the needs of a changing currency environment. We think that the provision of these systems assisted in the process of change and in the management of the growth of volume of currency transactions associated with the rapid expansion of world trade, employment and capital raising.

Better, more extensive and more timely information has underpinned the robust foreign exchange market, even as we expect better, more extensive and more timely information can improve the health of capital markets in general and the U.S. equities markets in particular.

In further support of this view, I would cite the General Accounting Office's investigations into the workings of the U.S. Government securities market. The overriding recommendation, rather than Congressional or regulatory action, was for the market participants to improve reporting of price data for investors.

Only time will tell if this is the right approach, but we have seen improved information access help elsewhere.

HOW INFORMATION GROWS

Reuters divides its information resources into three categories, the first having to do with our journalistic corps of over 1,000 reporters, editors and photographers around the world. This group is divided into two major sectors. We have journalists who report on political and general news events not only for use by newspapers and broadcasters of the world, but to support the activities in all the markets. Secondly, we have more focused reporting on economic news including the markets and events which affect them such as the periodic reports on trade consumer prices, unemployment and other indicators of world economies.

The second major category of basic information is what we call contributed data. This is information often input manually by traders. In the foreign exchange market an individual trader would key in information at his terminal which will appear on a page that is then displayed to other users of the Reuter Monitor system. More and more this area of contributed data is becoming automated ... computers talking directly to our computers provide the latest updates on bid and ask information in foreign exchange, and to a lesser degree in equities and commodities markets.

Lastly, the third major resource for Reuters is the established exchanges of the world. Reuters network connects 137 exchanges with the users of their price information and other data. In addition major official groups in many countries including a number of central banks use the Reuter system to post rates and information important to the markets they serve.

All of the information from these various sources then goes through a variety of processing levels. Reuters takes the data from all of these sources and puts them into easily read or understood formats on the screen using computers at centers located throughout the world. Additional processing of the data is done through software programs which we make available to clients. These programs can locate arbitrage opportunities in the case of foreign exchange or trading possibilities in the options markets through such products as Reuters Schwarzatron, named after the product developer, Steve Schwarz, and the Reuter Abacus -- a software package assisting in foreign exchange trading.

Another product of our information network is called Country Reports. This set of pages provides background economic, political and sociological information on a variety of countries around the world. Corporations, lenders and others use it in understanding the structure and recent history of those countries.

In addition, price and other information that flows through the Reuter Network is held in databases for graphic display providing yet another processed form of information.

The foreign exchange market is unlike securities markets. It has no exchange floor. It flows through all time zones over inter-linked communications from dealer to dealer.

When Reuters first was approached to develop its Monitor system to show rates, the change it brought in markets was instantaneous. Whereas before, when a phone call came in asking for a quotation, rates would change probably as a result of a phone call, after Monitor, rates were public and had to be much more realistic -- a trader who changed his rate from what was on the screen was forced to have a very good explanation.

Starting with the initial display of many currencies' prices directly from bank trading rooms, Reuters built a more extensive range of information pulling together, for instance, all of the quotations on the British pound on a

single page; putting the dollar on another page, drawing from all of the contributors to find complete display of dollar rates -- and on this process went to various currencies. Ultimately we arrived at a window on the foreign exchange market -- a single page on our system called "FXFX." This page draws from all of the preceding ones thereby showing the very latest rate that one can trade on anywhere in the world. And all of this progression was the direct result of the market telling us they needed it. These were facilities essential to the progress and better functioning of the market place.

GLOBALIZATION

Among the distinguished directors of Reuters is Walter Wriston, the former chairman and chief executive officer of Citicorp. Many years ago he identified information as the new international standard.

That he was correct was clear to many who operate in the international arena, but it didn't come home to many Americans until last October. Now the blink of any eye in Wall Street can cause a headache to emerge in Tokyo, and vice versa. And of course there are many similar effects in politics and commerce.

As a Reuter employee, I have long enjoyed the opportunity to talk with people whose circle of interest embraces world markets, but it is only since October that I find them across this country in large numbers. Money managers in Chicago and Minneapolis check the status of Tokyo and London as soon as possible at night and in the morning.

Portfolio managers who would never have looked at a foreign stock for investment now are buying more and more -- and they don't look quite so "foreign" any more.

In Reuters' own case, 43 percent of our common stock is held by American shareholders -- mostly institutions -- and you will find stock in our London-based company resides in the pension funds of employees at Shell, Ford, General Electric, Hewlett Packard and Sears to name just a few.

You have heard of the linkages of exchanges to create international trading opportunities. I won't go into those. But are you aware of what the information vendors have done? As a group, we have put together a huge and expensive system to allow investors to stay out on top of trading all across the globe. The Reuter network alone, with users in 133 countries, is unsurpassed. Not only do 137 exchanges report into our systems, but we have backed up the lines; we have backed up processing computers in a series of data centers in all important time zones and we continue to invest heavily in reliable communications systems for the future.

That is the kind of commitment to performance the information industry offers to the markets. If we can leave you with any message, it is that the industry stands ready to apply this great system to better market function. The decisions on what to disclose to improve markets will be up to the market participants and regulators, but be assured the vendors are prepared to help.

Once again, I want to thank the Committee for this opportunity to discuss financial information and we commend your efforts to improve market access and functionality.

With over 130 years in the information business, Reuters stands ready to assist in any way we can.

I would be happy to answer any questions.

STATEMENT OF
JAMES J. NEEDHAM
BEFORE THE SENATE COMMITTEE
ON
BANKING, HOUSING AND URBAN AFFAIRS
MAY 11, 1988

My name is James J. Needham. I served as a Commissioner of the Securities and Exchange Commision from July 1969 to July 1972. Thereafter, I was the first full time Chairman and Chief Executive Officer of The New York Stock Exchange until May of 1976. During the latter period I was active in the International Federation of Stock Exchanges and was President of that organiztion in 1976, the only American to have held that position. From September of 1982 until the end of 1985, I served as a U.S. Amabassador in connection with an International Exposition in Japan. My principal occupation has been service on Boards of Directors, many times pursuant to court orders, consulting to businesses and on a limited basis to governments on capital market matters. A more complete personal history of my business experience is attached to the copy of my testimony.

On March 2, 1972, while a Commissioner of the S.E.C., I delivered an address titled: "Temporizing, the Major Cause of Uncertainty in the Finanacial Community", a title which could easily be an appropriate introduction for this statement.

One of the significant features of our secondary markets for equity securities has been the ability provided to investors to exchange cash for securities, or the other way around, during normal business hours. Given the importance of that feature why does it appear there is so much timidity and uncertainty about what corrective actions should be taken to repair or restore the system so that it will continue to operate continuously in the post October 19th era?

Is that an unfair question to ask? I believe not based on my experience with attitudes during the back office crisis within the securities industry in the late sixties and early seventies. If you recall, the crisis then involved the safety of customers' cash and securities and the viability of the brokerage community. While there was much wailing about these problems among industry leaders, nothing significant happened until the Securities and Exchange Commission put on its hobnail boots and in its own inimical way managed to force the industry to do what was necessary to speedily resolve the problems.

Of course the Congress did not lag in this effort, it passed legislation to assure that the paperwork problem would not recur, and that the assets of customers held by brokers would not be jeopardized again. Equally important the Congress disposed of those apostates who questioned, whether the Commission had the authority to do what it did and went the full distance to give the Commission additional authority and responsibility to deal with comparable problems which might arise in the future. Similarly, in 1975, The Congress directed the Commission to implement a National Market System to integrate the flow of market information and the various clearing systems and to eliminate certain practices perceived to be anti-competitive. In retrospect, the Congress should have expanded the definition of a security to include derivative

Senator **Riegle**. Thank you. I appreciate that.

Gentlemen, let me thank all three of you. I know my colleagues—we have bills that we're acting on the floor right now and it requires the involvement of many. The chairman of the committee, Senator Proxmire, very much wanted to be here this morning, he has a major role on the floor and so he's had to be involved in that.

So I want to thank you for your patience. I want to thank you for the care in which you've prepared and brought your testimony and presented it today. We appreciate your appearance here.

The committee stands in adjournment.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

[Response to written questions follow:]

products, but in those days that was not an issue. Options were already trading on an Exchange registered with the Commission and we were naive enough to believe everyone knew the difference between a pork belly and a scion of an equity security.

The foregoing is a segment of the history of the past twenty years of Commission and Congressional action relating to the regulation of the Exchanges, the NASD and the brokerage community. With all of that experience, knowledge and statutory authority , the question is: how could the market break occur? The reports on that question contain fascinating insights into what went awry on that calamitous day. Of all, the Brady Commission report has become the focal point of the other reports and the commentary concerning the market break which indicates that despite disagreements with sections of the report, the thrust of it has been accepted. The Brady Report gives direction, but some of the remedial actions suggested are troublesome.

An inter-agency task force or super agency to deal with "issues which have an impact across the related market segments" is in conflict with the already accepted regulatory format of functional regulation which earlier was adopted by the Vice-President's task force as a generally preferred principle of regulation . As indicated above, a simple change in the law would vest the authority for regulation of all securities related market segments with the agency with the most expertise-the Securities and Exchange Commission.

The Federal Reserve Board should have the exclusive authority to control margin requirements on security transactions. Of course, The Board should have the authority to consult with federal regulatory bodies and the self regulatory bodies. Furthermore, equities and their derivative products are traded differently and fulfill similar yet different economic functions. Until adequate economic analysis demonstrates otherwise, margins should be imposed selectively and not uniformly.

No one who has been in the position of having the authority to close an Exchange and who has been confronted with occasions when such action was considered could enthusiastically support the proposal to close down an Exchange in the middle of a trading day regardless of how many points the market falls or rises. In addition to the serious damage which would be done to investor confidence in that particular market, the impact on all worldwide financial markets could be devastating. The practical side of that issue is determining at what prices stocks, for example, would open. Coordinating trading halts on a particular security among markets is another matter. Common sense clearly dictates that as a necessary procedure which would probably have been implemented long ago if the definition of securities had been expanded to include derivative products.

Computer directed trading has been characterized as a demon and as a saint. It is neither. It is neutral. It is the product of the accumulated knowledge of various sciences made useful by creative people. The proposals to ban this method of modern day arbitrage are nonsensical. What must be done is to adapt the trading mechanisms to this new practice. Apparently, this will require time. So for the short run, I reluctantly concede it is in everyone's interest to institute temporary fail safe procadures; provided, HOWEVER, that the "circuit breaker" concept is not in reality a renaming of a dangerous expedient practice of the pre-high tech era of inserting a penny in the fuse box, which I believe it will be proven to be.

The "front running" practice appears to be a clear violation of the rules governing "just and equitable principles of trade". The Commission can end that practice by bringing enforcement actions quickly.

Even if all these matters are resolved, an issue remains which some view as more important than any other. How do we define fair and orderly markets in the post October 19th environment? This question may seem to avoid the issue of the adequacy of the capital of market makers, but it does not for we must first determine what we have a reasonable right to expect a market maker to do in a variety of circumstances. Should it be the total exhaustion of all the resources of the market maker? I think not. Should the market maker have access to the window of the Federal Reserve Bank? I think not unless the market maker is willing to subject itself to utility type regulation. I say that without the vaguest notion as to how to design and implement such a proposal. I suspect we shall have to await responses to the other issues before this problem can be totally addressed.

In the meantime, we may have to accept more price volatility than we experienced previously. Frankly, I believe that volatility is not all that bad. It forces all participants in the market to accept their share of the responsibility to make our equity markets work properly and to foster an atmosphere where long term corporate performance conceivably might be given as much emphasis as short term performance in the pricing of shares.

In the March 1972 address, referred to above, I spoke to the future internationalization of financial markets. Not only did I mention the evolvement of a 24 hour market, but suggested that this occurrence could have enormous economic benefits world wide. Since then, I have not seen the intensive effort needed at the Federal level to assure that this nation's financial markets will continue to enjoy the preeminence that they have enjoyed. In a service economy, the growth in the financial markets has provided countless job opportunities for American workers. In fact, the financial services industry has been the growth industry of the 1980's. It should be apparent to all that it would be a tragedy for the American people if we were to relinquish our supremacy in this area as we have with autos, VCRs, TV, etc.

I applaud this Committee's willingness to address this important issue and sincerely hope that you will be successful in producing legislation which will provide reasonable assurance that all will be done to further stimulate growth in this area. I am sure you will not overlook the need for the appropriate Agencies to provide the levels of protection the investors in our markets have come to expect. In my mind there is a definite correlation between investor protection and the preeminence of our financial markets.

Thank you for giving me the opportunity to contribute to your deliberative process. If I can be of help in the future, I would be pleased to do so.

JAMES J. NEEDHAM

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PERSONAL

Born August 18, 1926, Woodhaven, New York; Cornell University 1944-1946; graduated St. John's University, B.B.A. 1951; Honorary L.L.D. St. John's University 1972.

Consult the following Directories for additional personal information: Men of Achievement, Notable Americans, Who's Who in America, Who's Who in the World, Who's Who in American Politics.

BUSINESS ACTIVITIES

Member of the Boards of Directors of numerous business corporations.

Ambassador of the United States of America, to the International Exposition, Japan, 1982-198~~4~~5

Chairman and Member of the Board of Directors of American Savings and Loan Assoc.; Southwest Savings and Loan Assoc.; Home Saving and Loan Assoc.; 1980-1984

Distinguished Professor in the Graduate Division of the College of Business Administration of St. John's University, 1977-1978.

Chairman and Chief Executive Officer of the New York Stock Exchange, August 1972 to May 1976.

Commissioner of the Securities and Exchange Commission, July 1969 to July 1972.

Member of the Executive Committee and Managing Partner of the New York practice of McGladrey, Hendrickson & Pullen, Certified Public Accountants, 1957-1969.

Managing Partner, Raymond T. Hyer & Co., Certified Public Accountants, 1955-1957.

Senior Accountant, Price Waterhouse & Co., Certified Public Accountants, 1947-1955.

NEWS

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REMARKS OF

JAMES J. NEEDHAM, COMMISSIONER

SECURITIES AND EXCHANGE COMMISSION

before the

New York Chamber of Commerce
New York, New York

"TEMPORIZING, THE MAJOR CAUSE OF UNCERTAINTY IN THE FINANCIAL COMMUNITY"

March 2, 1972

is required is allegiance to the goal of a central securities market. Until exchanges concretely demonstrate the capability to subordinate their vested interests to that goal, I will continue to urge that they must all be merged into one corporate entity which will not be blinded by parochial interests. The alternative, in the minds of some, is government ownership of the securities markets. And the consequences of the federal government of a capitalistic society taking over its capital markets could well provide history with its first example of a nation which committed suicide by devouring itself.

There is another compelling reason for automating our securities markets. In the past, I have urged that our securities markets remain open for business 24 hours a day in order to accommodate all time zones around the world. My proposal is not based on today's level of international business but is intended to achieve for the U. S. the status of being the primary trading market for all foreign as well as domestic securities.

If we are successful in becoming the primary securities market we will also establish ourselves as the port of entry for all capital seeking investment regardless of its country of origin. What a boon this could be to us and the other people of the world, especially for those citizens of underdeveloped countries, because all of the resourcefulness, imagination, talent and know-how of American businessmen would be at work. Our investment bankers would travel the globe as international citizens looking for investment opportunities on behalf of their world-wide clientele. They would also become a powerful force for peace if they succeed in reducing economic uncertainty by raising the standard of living of people less fortunate than others.

I firmly believe such activities, motivated by practical business considerations, would succeed. That motivation may not be in vogue everywhere, but it brought this country to the level of prosperity it enjoys. Let's not forget that simple fact while we search for a better life.

Before we can become the investment bankers for the entire world, however, we must take certain preparatory measures.